

# Statement of Principles

## Financial Instruments

prepared by:  
Public Sector Accounting Board

June 2007

Comments are requested by  
September 21, 2007

# PSAB

## **Commenting on This Statement of Principles**

This Statement of Principles is issued by the Public Sector Accounting Board. The members of the Board are drawn from government, public accounting, business and academe. All members serve as individuals and not as representatives of their governments, employers or organizations.

Statements of Principles propose key principles and definitions that the Board expects to include in a future Exposure Draft.

Individuals, governments and organizations are invited to send written comments to the Board on the principles and definitions set forth. Comments are requested from those who agree with this Statement of Principles as well as from those who do not.

**To be considered, comments must be received by September 21, 2007, addressed to:**

**Tim Beauchamp, Director  
Public Sector Accounting  
277 Wellington Street West  
Toronto, Ontario M5V 3H2**

For ease of handling, we prefer comments to be sent by e-mail (in Word format), to:  
[ed.psector@cica.ca](mailto:ed.psector@cica.ca)

## Highlights

The Public Sector Accounting Board (PSAB) proposes, subject to comments received on this Statement of Principles, to expose FINANCIAL INSTRUMENTS, as new Handbook material. The Section(s) would apply to all governments.

### Main features

The main features of this Statement of Principles are as follows:

- Fair value measurement is proposed for derivatives and portfolio investments quoted in an active market.
- Hedge accounting treatment is permitted for certain documented hedging relationships where they are demonstrated to be highly effective.
- Flexibility to designate non-derivative financial assets and non-derivative financial liabilities to be reported at fair value is permitted in cases where more relevant information will result, as it:
  - eliminates or significantly reduces a measurement or recognition inconsistency; or
  - is the basis on which a group of financial assets, financial liabilities or both are managed and performance is evaluated, in accordance with a documented risk management or investment strategy.
- Two measurement categories are proposed for financial instruments:
  - cost or amortized cost; and
  - fair value (with gains and losses recognized in the statement of operations).
- Specific disclosure and presentation requirements for financial instruments are suggested.

Each principle is stated, together with supporting commentary, to assist readers in understanding how each issue was evaluated. The document is organized into three sections.

#### *Section A: Financial instruments – recognition and measurement*

These proposals establish that:

- a financial asset or a financial liability is recognized when a government becomes a party to the contractual provisions of the instrument;
- a financial liability is removed when the contract is discharged, cancelled or expires;
- financial assets and financial liabilities are initially recognized at fair value and transaction costs are added only when an item will be measured in subsequent periods at amortized cost;
- fair value measurement in subsequent periods is applied to derivatives, portfolio investments traded in an active market, and items that can be and are designated by the government to be measured at fair value; (otherwise, financial assets and financial liabilities are measured at amortized cost);
- the effective interest method is applied to measure items categorized for measurement at amortized cost;

- gains and losses arising from a change in the fair value of a financial instrument not accounted for in accordance with the hedge accounting provisions are recognized in the statement of operations;
- objective evidence of impairment in a financial asset carried at amortized cost is considered at each reporting date;
- reclassification of a financial instrument may occur in four instances and how each circumstance impacts subsequent measurement; and
- embedded derivatives must be identified and when to account for them separately.

### *Section B: Hedge accounting*

These proposals establish:

- conditions for hedge accounting to expand the scope of risks that may be hedged compared to the current PSA Handbook;
- that hedging instruments are generally limited to derivatives, other than in a hedge of the risk of changes in foreign exchange rates;
- accounting specific to fair value and cash flow hedges;
- that any ineffectiveness in achieving offsetting changes in fair value or cash flows attributable to the hedged risk must be recognized in the statement of operations; and
- situations when hedge accounting is discontinued.

### *Section C: Disclosure and presentation*

These proposals establish:

- disclosure requirements to support an understanding by users of:
  - the significance of financial instruments for a government’s financial position and changes in its financial position;
  - the government’s use of hedge accounting;
- the principle that the nature and extent of risks arising from financial instruments to which the government is exposed at the reporting date is disclosed; and
- when financial assets and financial liabilities may be offset.

The supporting Appendices contain important information: definitions, fundamental principles, the scope of application, the impact of the proposals on key financial reporting indicators, as well as an illustration of presentation for a cash flow hedge, and the alternatives evaluated.

## **Background**

In March 2006, a SOP addressing key definitions and fundamental questions specific to recognition and measurement of derivatives was issued. Responses supported the definitions proposed for a financial instrument and a derivative, the conclusion that derivatives represent rights and obligations that meet PSAB’s definitions of assets or liabilities, and the need for a hedge accounting standard broader in scope than PSAB’s existing standard. Some respondents indicated a need to understand how PSAB proposed to deal with the measurement of non-derivatives and hedge accounting. PSAB has prepared this document to provide a comprehensive set of proposed principles that would apply to public sector financial instrument and hedge accounting standards.

## **Equivalent CICA Handbook – Accounting standards**

For the most part, the scope of the proposed principles is equivalent to CICA Handbook – Accounting standards. PSAB examined these standards, evaluating key questions in relation to its definitions of assets and liabilities and the objectives of government financial reporting. Unlike the private sector standards, PSAB is recommending only two classifications and reporting bases. In many cases, items may be reclassified after initial recognition, making the fair value option more responsive as an alternative to hedge accounting. The scope and application of hedge accounting is in common with the CICA Handbook – Accounting, except that self-sustaining foreign operations are not encountered in public sector reporting.

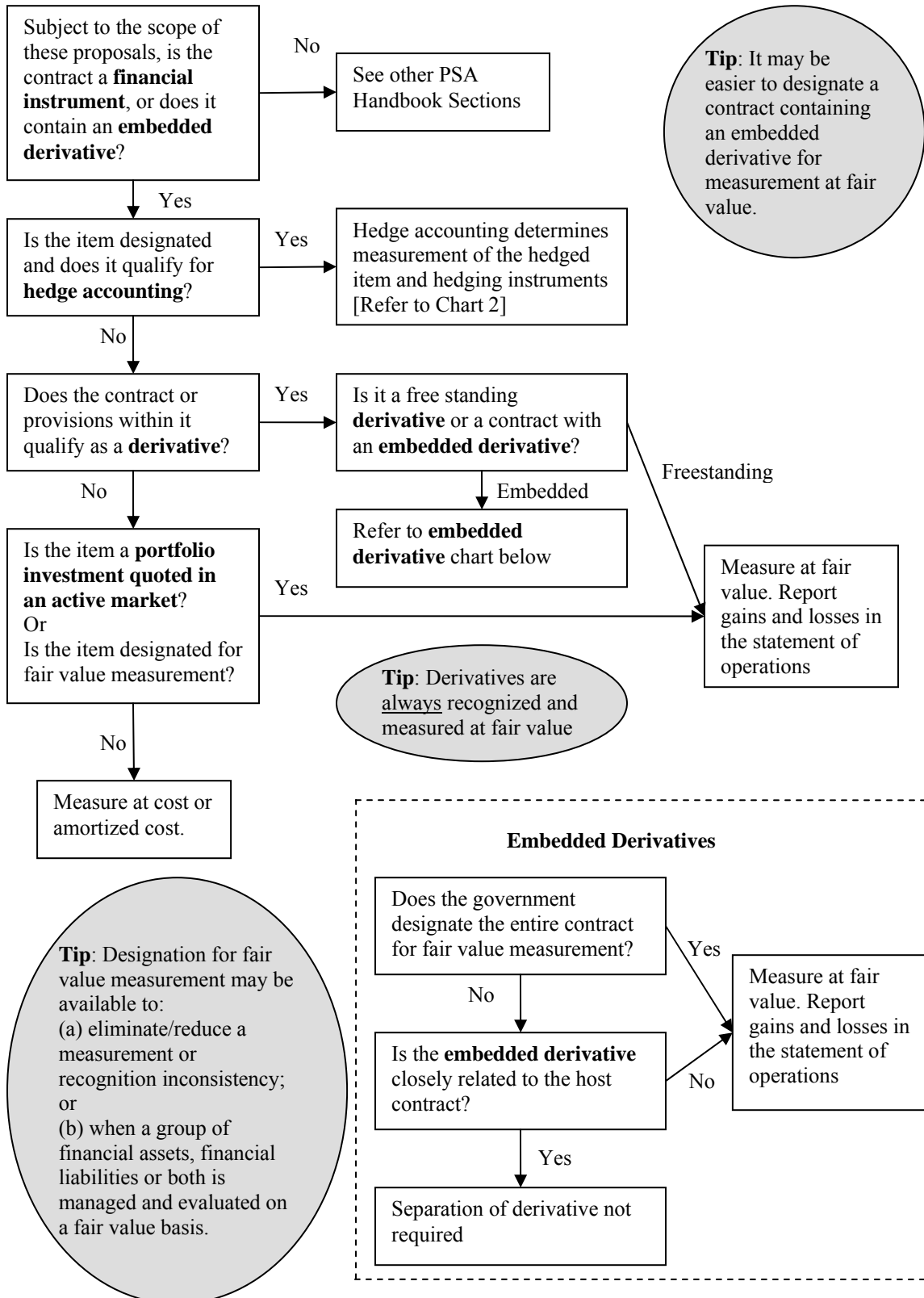
### **Overview charts**

Two overview charts appear on the pages that follow. They are provided to assist readers in understanding the detailed principles proposed. As overview documents, they do not address all provisions or alternatives.

### **Web presentations**

Web-based presentations explaining key elements of these proposals will be available.

**Chart 1: Overview of recognition and measurement proposals**



## Chart 2: Overview of hedge accounting proposals

### Step 1

<b>The hedged item</b>
Identify a risk exposure(s) in all or a specified portion of a recognized asset, a recognized liability or a highly probable forecast transaction that a government seeks to modify in accordance with its risk management objective and strategy.

**Tip:** Groups of assets or liabilities sharing the same risk exposure may also qualify.

### Step 2

<b>The hedging instrument</b>
Identify a qualifying hedging instrument(s) offsetting risk exposure(s) identified in the hedged item(s).

**Tip:** A qualifying hedging item may be all or a specified percentage of a derivative or group of derivatives. Non-derivative assets or non-derivative liabilities only qualify as a hedge of foreign currency risk.

<b>The hedging relationship</b>
Evaluate the hedging relationship in relation to management's risk management objective and strategy. Determine whether it is highly effective in offsetting: (a) changes in fair value ( <b>fair value hedge</b> ); or (b) variability in cash flows ( <b>cash flow hedge</b> ).

**Tip:** Hedge accounting is optional. Designation and measurement of groups of assets, groups of liabilities or both managed on a fair value basis may be a practical alternative.

### Step 3

<b>Designate hedge accounting</b>
Hedge accounting commences only after : (a) formal documentation is in place; (b) the relationship is expected to be highly effective in achieving offsetting changes in the fair value or cash flows attributable to the hedged risk; and (c) prospective and retroactive testing supports the assertion of effectiveness.

**Tip:** If qualifying critical terms of the hedging instrument match the hedged risk, no ineffectiveness may be assumed.

### Each reporting period

<b>Maintaining hedge accounting</b>
Test effectiveness retroactively and prospectively. Assess whether the hedging relationship has been and is expected to be effective. Report ineffectiveness in the hedging relationship in the statement of operations. In the case of forecasted transactions, ensure that it remains probable that the transaction will occur and present an exposure to variations in cash flows ultimately affecting the periodic surplus or deficit indicator.

**Fair value hedges:** Account for gains and losses on the hedged item and hedging instrument in accordance with paragraph .89

**Cash flow hedges:** Account for gains and losses on the hedging instrument in accordance with paragraph .97

When hedge accounting is discontinued, consult former fair value hedges (see paragraph .108) and former cash flow hedges (see paragraph .109).

## Comments requested

PSAB welcomes comments on all aspects of the Statement of Principles. Comments are most helpful if they relate to a specific principle, paragraph or group of paragraphs and, when expressing disagreement, they clearly explain the problem and indicate a suggestion, supported by specific reasoning, for alternative wording.

In particular, respondents are requested to provide responses to the following questions:

### *Fundamental principles*

1. To address reporting on financial instruments, PSAB has evaluated the fundamental issues (see Appendix C: Fundamental Principles) in relation to the objectives of government reporting. Do you agree with the overall approach that an eventual standard should require the recognition and measurement of derivatives at fair value?

If you disagree, explain how an alternative approach would provide external users with more relevant information and how differences would be treated when governments consolidate entities applying the AcSB standards.

### *Section A: Financial instruments — recognition and measurement*

2. Do you agree with the principle proposed to govern recognition of financial assets and financial liabilities?
3. Do you agree that a government would remove a financial liability (or a portion of a financial liability) from its statement of financial position when, and only when, it is extinguished? If you disagree, are there specific reasons unique to governments that merit an approach at variance from that which applies to AcSB standards?
4. Two measurement categories are proposed: cost or amortized cost, and fair value.
  - (a) Do you agree with the definitions establishing when each category would apply (see Appendix A, paragraphs A.06 and A.07)?
  - (b) Do you agree that reporting portfolio investments quoted in an active market at fair value provides more relevant information to users (see Appendix A, paragraph A.08)?
  - (c) Do you agree that reducing the number of financial instrument categories from four (as in the CICA Handbook – Accounting) to two will reduce the effort required to initially designate items without compromising the objectives of government reporting?
  - (d) Do you agree that enabling the fair value measurement option will reduce the need for hedge accounting? Are the requirements that determine when it may be applied appropriate and practical?
  - (e) Do you agree with the definition of transaction costs and the accounting proposed (see Appendix A, paragraph A.12)?
  - (f) Do you agree that standards presently contained in PORTFOLIO INVESTMENTS, Section PS 3040 and LOANS RECEIVABLE, Section PS 3050 should continue to determine the initial measurement value where the item contains concessionary terms?

5. Do you agree that the effective interest method (as defined in Appendix A, paragraph A.09) will support consistent calculation of the amortized cost of a financial asset or a financial liability? Is this the most relevant method to apply?
6. Do you agree that gains and losses (excluding those within the scope of hedge accounting) should in all cases be reported in the statement of operations?
7. Do you agree with the principle addressing impairment of financial assets?
8. Do you agree with the principles that would apply when financial instruments are reclassified?
9. Do you agree with the principles proposed that would determine when embedded derivatives are separated from their host contract?

*Section B: Hedge accounting*

10. Do you agree with the hedge accounting principles and definitions (see Appendix A, paragraphs A.13-A.17) proposed that:
  - (a) enable two types of hedging relationships: the fair value hedge and the cash flow hedge;
  - (b) enable hedging of anticipated transactions and the principles that would apply to recognition of the associated gains and losses;
  - (c) determine the scope of instruments permitted to be used as hedging instruments and as hedged items;
  - (d) require professional judgment be applied in assessing whether a hedging instrument achieves a high correlation in offsetting changes in fair value or offsetting cash flows attributable to the risk being hedged;
  - (e) require recording of ineffectiveness in the statement of operations;
  - (f) determine the accounting for gains and losses on items that are part of a fair value hedge;
  - (g) require recognition of gains and losses directly in net debt for cash flow hedging instruments determined to be an effective hedge; and
  - (h) determine accounting for discontinued hedging relationships?

*Section C: Disclosure and presentation*

11. Do you agree with the proposals that:
- (a) apply to disclosures of the significance of financial instruments to a government's financial position and changes in its financial position;
  - (b) apply to disclosures of hedge accounting and its impact;
  - (c) users of government financial statements should be provided with information allowing evaluation of the nature and extent of risks arising from financial instruments to which the government is exposed at the reporting date; and
  - (d) establish when items are offset and the net amount reported in the statement of financial position?
12. Synthetic instrument accounting was considered during development of these proposals (see Appendix H: Synthetic Instrument Accounting). An exception to the principles proposed individual contracts are not recognized at fair value, nor are gains and losses recognized for the contracts combined as a synthetic instrument. Measurement is premised on the assumption that the items will be held to term and perform as anticipated.

Do you agree that synthetic instrument accounting should be eliminated?

If you disagree, explain why information should be presented to external users combining items when contractual terms allow them to be managed separately. If volatility in the statement of operations is a key concern, explain why the options to use either hedge accounting or the fair value measurement option are not adequate alternatives.

# Financial Instruments

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### Defined terms

**Bold type** is used to highlight the first time a defined term appears within the body of the text. The defined terms, together with supporting explanations, appear in Appendix A.

## Background

- .001 In March 2006, the Statement of Principles (SOP), “Recognition and Measurement of Derivatives,” addressing key definitions and fundamental questions specific to recognition and measurement of **derivatives** was issued.<sup>1</sup> Responses supported the definitions proposed for a **financial instrument** and a derivative, the assertion that derivatives represent rights and obligations that meet PSAB’s definitions of assets or liabilities, and the need for a hedge accounting standard broader in scope than PSAB’s existing standard.
- .002 Some respondents expressed the view that PSAB needed to explain how it proposed to deal with the measurement of non-derivatives and its hedge accounting proposals. They commented that without this information, it was not possible to evaluate a proposal to recognize and measure derivatives at **fair value**. In issuing an SOP without these elements, PSAB sought to evaluate the accounting for derivatives by applying its conceptual framework. PSAB has prepared this document to provide a comprehensive set of principles that it proposes would apply to public sector financial instrument and hedge accounting standards.
- .003 In developing its proposals, PSAB considered the definitions of assets and liabilities and the objectives established for government financial statements.<sup>2</sup> These definitions share common elements with definitions that underpin the accounting standards issued by the Accounting Standards Board (AcSB standards). However, the objectives of financial reporting PSAB has adopted identify reporting differences owing in part to the broad group of identified users of government financial statements and the emphasis users place on assessing accountability and stewardship. Similarities in the definitions mean that existing AcSB standards are generally a logical starting point for the development of standards similar in scope. However, PSAB appreciates its proposals must respect inherent differences in governments and the uses being made of their financial statements.
- .004 In setting its strategic direction for publicly accountable Canadian enterprises, the AcSB has put in place a plan to adopt the standards issued by the International Accounting Standards Board (IASB). Fortunately, in the case of accounting standards for financial instruments, there is consensus on fundamental principles and limited differences in how they are enabled. Where it was determined that application of the principles adopted in the AcSB standards are appropriate in supporting the objectives of financial reporting by governments, the wording in

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<sup>1</sup> Key aspects of the March 2006 SOP are summarized in Appendix C: Fundamental Principles. The Appendix explains:

- (a) why derivatives meet PSAB’s definitions of assets or liabilities;
- (b) that fair value is the only relevant measurement basis for derivatives; and
- (c) that amounts recognized as a result of hedge accounting are reported only if they meet PSAB’s definitions of assets or liabilities.

<sup>2</sup> FINANCIAL STATEMENT CONCEPTS, Section PS 1000, and FINANCIAL STATEMENT OBJECTIVES, Section PS 1100, detail the conceptual framework and objectives of government financial statements.

PSAB's proposals adheres to the principles adopted by the IASB and AcSB. Generally, the IASB wording has been favoured, given expectations that the IASB standard will eventually be adopted in the future as Canadian GAAP. Generally, options within the AcSB standard that permit an accounting policy choice to mitigate US GAAP differences have been eliminated. These situations are identified in the commentary.

- .005 The International Public Sector Accounting Standards Board (IPSASB) has not yet commenced a project to examine the recognition and measurement of derivatives. To a great degree, the base line set of International Public Sector Accounting Standards (IPSAS) has been developed applying principles contained in IASB standards that are similar in scope. To date, financial instruments standards issued by IPSASB have been limited to disclosure only, IPSAS 15, "Financial Instruments: Disclosure and Presentation." This standard includes a definition for financial instrument in common with this proposal. Although IPSAS 15 describes the features of a derivative, it does not define the term.
- .006 Items that will continue to be accounted for in accordance with existing CICA Public Sector Accounting Handbook (PSA Handbook) standards and items that are outside of the scope of these proposals are detailed in Appendix B: Scope.

## **Section A: Financial instruments — recognition and measurement**

- .007 Responses to the SOP, "Recognition and Measurement of Derivatives," indicated broad support for the proposed definitions for a financial instrument and a derivative. For details and background, see Appendix C: Fundamental Principles.

### **Recognition**

- .008 The contract establishing a financial instrument creates, at inception, rights and obligations to receive or deliver economic benefits resulting from that instrument. Any assessment of the likelihood of receiving or delivering those benefits, and the amount of those benefits, is a measurement issue rather than a recognition issue. Therefore, it is the act of becoming a party to a financial instrument contract that determines the timing of recognition.
- .009 PSAB proposes the following principle for recognition of financial instruments, which is consistent with the AcSB standard.

#### **Principle**

A government should recognize a **financial asset** or **financial liability** on its statement of financial position when, and only when, the government becomes a party to the contractual provisions of the financial instrument.

- .010 In the case of purchases and sales of securities transacted through a recognized exchange,<sup>3</sup> PSAB proposes trade-date accounting<sup>4</sup> would apply. The AcSB standards provide entities with the option to either apply trade-date or settlement-date accounting<sup>5</sup>. In proposing consistent use of trade-date accounting, PSAB views this as an opportunity to simplify the standard by eliminating what is understood to be an unnecessary option in the case of reporting by governments.
- .011 PSAB does not believe mandating trade-date accounting would present significant issues for governments consolidating those governmental units applying the CICA Handbook – Accounting for their entity level statements. Such entities have the alternative of adopting trade-date accounting themselves to eliminate the potential for differences. Further, should a business reason dictate use of settlement-date accounting, an analysis of unsettled trade positions is readily completed.

### **Derecognition of a financial liability**

- .012 LIABILITIES, Section PS 3200, does not specifically address when to derecognize a financial liability. The AcSB standard requires **derecognition** when a liability is contractually extinguished.
- .013 The following principles are consistent with the AcSB standard.

#### **Principles**

A government should remove a financial liability (or a part of a financial liability) from its statement of financial position when, and only when, it is extinguished (i.e., when the obligation specified in the contract is discharged or cancelled, or expires).

An exchange between an existing borrower and lender of debt instruments with substantially different terms should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, should be recognized in the statement of operations.

<sup>3</sup> Technically, this is a regular-way transaction. Contrast this with contracts requiring or permitting net settlement of the change in the value of the contract. Net settled contracts are not regular-way contracts.

<sup>4</sup> Trade-date accounting refers to the recognition of an asset to be received and the liability to pay for it on the day of the trade.

<sup>5</sup> Settlement-date accounting recognizes the item when the security is delivered to the purchaser. Rules established for individual financial markets specify the settlement date. In Canada, three days following the date of the trade is the norm.

If a government repurchases a part of a financial liability, the government should allocate the previous carrying amount of the financial liability between the part that continues to be recognized and the part that is derecognized based on the relative fair values of those parts on the date of the repurchase. The difference between the carrying amount allocated to the part derecognized and the consideration paid, including any non-cash assets transferred or liabilities assumed, for the part derecognized should be recognized in the statement of operations.

- .014 The derecognition principle has conceptual symmetry with the aforementioned recognition principle. As financial liabilities are contractually based, the proposed principle accomplishes this by establishing a consistent requirement for the removal of a liability based on the discharge, cancellation or expiration of provisions in the contract that established the liability.
- .015 PSAB recognizes that application of this principle may have implications for governments that presently reacquire their own debt securities and who do not immediately cancel those securities and account for any gain or loss arising from the repurchase. The AcSB standard requires an issuer to treat a repurchase as an extinguishment even where the issuer is a market maker in the instrument or intends to resell it in the near term.
- .016 Application of this principle requires a debtor to have legal release, prohibiting removal of a liability when assets are placed in a trust for a future debt extinguishment (sometimes called “in-substance defeasance”).
- .017 In adopting these principles, PSAB did not extensively consider intention-based accounting for liability extinguishment, viewing it as diminishing the neutrality of financial statement reporting. PSAB is of the view that financial statements should present assets and liabilities based on their contractual terms and not permit the offsetting of items to present a position based on the intentions of government managers or its policy makers. Presentation based on policy intentions subject to future reconsideration increases the risk users may base their conclusions on their understanding of those intentions rather than the requirements of the underlying contracts.

### **Initial measurement of financial assets and financial liabilities**

- .018 PSAB proposes two measurement categories for financial instruments:
  - (a) cost or amortized cost; and
  - (b) fair value (with gains and losses recognized in the statement of operations).
- .019 The amount recorded when an item is initially recognized is generally its fair value. Adding **transaction costs** to fair value results in an exception. Other exceptions arise when financial assets include concessionary terms or when realization is based on future appropriations. The principles that apply to measurement of an item when it is acquired or issued are detailed in this section. How items in each category are measured in subsequent periods appears later.

- .020 Governments presently measure financial assets and financial liabilities at cost when they are initially recorded. For arm's length transactions, at the instant a financial asset is acquired or a financial liability incurred, cost will often equal fair value, in the absence of transaction costs. If provisions in the standard include fair value categories, dealing with transaction costs is an issue requiring attention. For instance, governments will incur transaction fees when purchasing a security from a broker dealer, restructuring a loan or debt and in issuing new debt.
- .021 PSAB proposes the following principles:

### Principles

When a financial asset or financial liability is recognized initially, a government should measure it at its fair value.

For **financial instruments carried at fair value**, all transaction costs should be recognized immediately in the statement of operations. For financial assets and financial liabilities other than financial instruments carried at fair value, transaction costs directly attributable to acquisition or issue are added in establishing the **amortized cost of a financial asset or financial liability**.<sup>6</sup>

- .022 Transaction costs are treated differently depending on the category of the financial instrument. Transaction costs are not added to items that will be remeasured at fair value in subsequent reporting periods, as to do so would be inconsistent with measurement of other items in that category. Including transaction costs would cause the item to be recorded at fair value plus transaction costs. In the absence of a change in the value of the instrument, the transaction costs would need to be written off the first time the item was remeasured.
- .023 Provisions contained within LOANS RECEIVABLE, Section PS 3050, that impact initial measurement of loans made by governments in certain circumstances will continue to apply. These provisions reduce carrying value on initial recognition for loans containing forgivable conditions, significant concessionary terms and loans expected to be recovered from future appropriations.
- .024 In the case of an inter-governmental transfer of a financial asset, BASIC PRINCIPLES OF CONSOLIDATION, paragraph PS 2500.15, requires elimination of gains and losses upon consolidation. PSAB does not propose to prohibit a government acquiring a financial instrument through an inter-governmental transfer from then designating it as a financial instrument carried at fair value. Any gains and losses accruing to the date of transfer (unless the item is measured at fair value with gains and losses to the statement of operations by the transferor) would be eliminated on consolidation until realization. An amendment to

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<sup>6</sup> Throughout this document, when reference is made to amortized cost, it is determined in accordance with the definition in Appendix A, paragraph A.06. In some cases this may be equivalent to historical cost.

paragraph PS 2500.15 would be required to clarify that in the case of financial instruments carried at fair value, gains and losses subsequent to the transfer would not be eliminated. This amendment is necessary to ensure that where principles supporting fair value measurement have been adopted, they will be achieved. The detailed standards proposal will need to address accounting for items transferred by governmental units applying the standards of the CICA Handbook – Accounting and designated into categories not provided for in the public sector standard.

- .025 Similarly, INVESTMENTS IN GOVERNMENT BUSINESS ENTERPRISES, Inter-organizational transactions and balances, Section PS 3070 requires elimination of inter-organizational gains and losses on assets remaining within the government reporting entity at the reporting date. The detailed standards proposal will update these requirements in a manner consistent with changes that would apply to inter-governmental transfers.
- .026 FINANCIAL INSTRUMENTS — RECOGNITION AND MEASUREMENT, CICA HANDBOOK – ACCOUNTING Section 3855, permits entities a choice in the treatment of transaction costs for items other than those that will be remeasured at fair value with gains and losses to net income in subsequent periods. An entity may adopt an accounting policy to expense transaction costs or include them in the cost base. The equivalent IASB standard does not permit a choice. PSAB is proposing to converge with IASB and simplify the standard.
- .027 In the case of accounting by a government for a modification or exchange of debt instruments, it is proposed that a requirement similar to that provided in the IASB standard<sup>7</sup> be made that any costs or fees incurred on a debt extinguishment be accounted for as part of the gain or loss on the debt extinguishment. In proposing this treatment, an accounting policy choice that exists in the AcSB standard for the purpose of facilitating US GAAP convergence would not be available to governments.

### **Subsequent measurement of financial assets and financial liabilities**

- .028 Measurement of financial assets and financial liabilities at other than historical cost in periods subsequent to initial recognition has the potential to significantly influence key measures in PSAB’s present reporting model. In the case of derivatives, the case is compelling and essential in achieving useful and transparent information about the derivative positions a government holds. Consideration of the broader application of fair value reporting is a consequential outcome of recognizing derivatives at fair value. In many cases, derivatives will have been entered into to manage specific risks. Provisions in Section B: Hedge Accounting detail the special accounting proposed for situations where a hedging relationship can be established. This section addresses the need for measurement alternatives for those situations where a hedging relationship has not been established.

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<sup>7</sup> International Financial Reporting Standard IAS 39, *Financial Instruments: Recognition and Measurement*, paragraph AG62.

- .029 In developing a proposal addressing the subsequent measurement of financial assets and financial liabilities, PSAB evaluated:
- (a) the objectives of the users of financial statements and the contribution that a broad application of fair value reporting could provide;
  - (b) the impact on established financial statement measures; and
  - (c) the importance of neutrality in financial statement reporting by governments.
- .030 For the reasons set out in the following paragraphs, PSAB believes it has defined significant differences in the objectives of government financial reporting that warrant variation in the approach to the reporting of non-derivative financial assets and non-derivative financial liabilities from that adopted by the AcSB. PSAB proposes the following principle.

### **Principle**

After initial recognition, a government should measure financial assets and financial liabilities at amortized cost using the effective interest method, except for items that are financial instruments carried at fair value.

- .031 The AcSB and IASB standards are based on the principle that fair value is the most relevant measure for financial instruments. An entity has the option to measure any financial instrument at fair value (required in the case of derivatives). Generally, gains and losses are reported in determining net income, although certain financial assets may be designated as available-for-sale. In the case of available-for-sale items, gains and losses are reported as part of comprehensive income until derecognized when any gains and losses are transferred to net income. If an asset is a debt security that the entity expects to hold to maturity, it can designate the item to be measured at amortized cost. Loans and receivables (other than debt securities) are, by default, measured at amortized cost unless otherwise designated. Amortized cost is the basis of measurement for liabilities not designated for measurement at fair value with gains and losses to net income.
- .032 In evaluating the fundamental decisions underlying the AcSB approach, PSAB considered whether users are as concerned in obtaining fair value information for all elements of government financial statements. FINANCIAL STATEMENT OBJECTIVES, Section PS 1100, highlights differences between the goals of government and business.
- .033 In preparing their fiscal plans, governments focus on raising the revenues necessary to support their revenue requirements. Governments have the power to tax and are not focused on building shareholder wealth through the profitable sale of goods and services. In contrast to the motivations that influence users of private sector financial reports, the public sector emphasis on reporting to assess stewardship increases the need for an approach that respects the need for

- information about past and future cash flows rather than reporting predominantly based on fair value measurement.
- .034 Broad application of fair value accounting is conceptually attractive in many ways. However, it remains controversial. In developing its proposals, PSAB sought to maintain the relevance of its existing indicators while ensuring the recognition of derivatives and allowing for fair value measurement when it contributes to increasing the relevance of financial statements.
- .035 These proposals will:
- (a) require fair value measurement for derivatives and **portfolio investments quoted in an active market**;
  - (b) permit hedge accounting treatment for certain documented hedging relationships where they are demonstrated to be highly effective; and
  - (c) provide the flexibility to designate recognized non-derivative financial assets and non-derivative financial liabilities to be reported at fair value in cases where more relevant information will result, as it:
    - (i) eliminates or significantly reduces a measurement or recognition inconsistency; or
    - (iii) is the basis on which a group of financial assets, financial liabilities or both are managed and performance is evaluated, in accordance with a documented risk management or investment strategy.
- (Please review the definition of “financial instruments carried at market value” (Appendix A, paragraph A.07(c)) setting out qualifying criteria for use of the fair value measurement option.)
- .036 Financial instruments carried at fair value are items requiring subsequent remeasurement at each financial reporting date. Any gains and losses are recognized in the statement of operations. Derivatives and portfolio investments are, by default, measured at fair value. In addition, the definition enables the fair value measurement option that permits a government to designate non-derivative financial instruments for fair value measurement under qualifying circumstances.
- .037 Responses to PSAB’s Request for Information as to hedge accounting by governments reinforced the need to evaluate the fair value measurement option. PSAB supports its adoption to increase the standard’s flexibility and to reduce the need for hedge accounting, simplifying its application. Some governments manage groups of financial assets, financial liabilities or combinations of such items to reduce the risk of fluctuations in their fair value. Hedge accounting provisions may be restrictive or it may be difficult to properly assess any ineffectiveness in the risk management strategy.
- .038 The fair value measurement option does not require governments to measure additional financial instruments at fair value. Rather, it is available to respond in situations where financial assets or financial liabilities or both are managed on a fair value basis, or in situations where different bases of measurement create a measurement or recognition inconsistency (sometimes referred to as “an accounting mismatch”). An alternative to hedge accounting, this provision allows

- designated items to be measured at fair value with gains and losses reported in the statement of operations. Consequently, governments are relieved from the obligation to document hedge accounting relationships and to periodically test designated items for effectiveness as any ineffectiveness is recognized in each period when the items are remeasured.
- .039 Further, designation of an item as a financial instrument carried at fair value subsequent to initial recognition would be permitted, subject only to the qualifying criteria. PSAB believes this flexibility, not available in the AcSB and IASB standards, is desirable for two reasons. First, it reflects the management techniques governments apply to reduce exposures to specific risks and the need to periodically rebalance components. Second, by streamlining the categories of financial instruments, the requirement to actively designate items on initial recognition is significantly reduced or eliminated.
- .040 Portfolio investments quoted in an active market are generally liquid and fair value is a superior indicator when compared to cost. Application of fair value eliminates the need to consider whether there is temporary impairment and inconsistencies in application of this requirement. PSAB believes this will improve the information provided by all its financial statement measures, providing more relevant information as to the government's ability to finance its activities and future services. Measurement of all portfolio investments quoted in an active market at fair value will ensure neutrality in reporting of this financial statement item. For these reasons, PSAB proposes to include portfolio investments quoted in an active market in the category of financial instruments that must be measured at fair value.
- .041 For financial instruments accounted for at amortized cost, consistency is enhanced when one method is adopted for amortization. PSAB presently states that the effective interest rate method is preferred in accounting for investment and loan discounts.<sup>8</sup> Other methods, such as straight-line amortization are not presently excluded. The **effective interest method** is considered conceptually superior as it exactly discounts estimated future cash payments or receipts throughout the life of the financial instrument. In comparison, application of the straight-line method results in an equal amount being reported in operations in each individual period. Although frequently immaterial, it is possible that this difference could be significant. PSAB proposes to adopt the effective interest method as it is conceptually superior and consistent with both the AcSB and IASB standards. The conformed definition of effective interest method will supersede the existing definition (effective interest rate method) in PORTFOLIO INVESTMENTS, paragraph PS 3040.02(d).
- .042 PSAB considered the extent to which relevance would be increased by requiring other financial instruments to be reported at fair value. Fair value measurement has the potential to significantly impact the key measures in the present financial reporting model (see Appendix D: Impact of Proposals on Key Measures).

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<sup>8</sup> See PORTFOLIO INVESTMENTS, paragraph PS 3040.20, and LOANS RECEIVABLE, paragraph PS 3050.25.

Reporting debt obligations at fair value would mean that interest rates, credit quality and market conditions would impact the measure of surplus or deficit for the period to a much greater extent than is presently the case. Such an approach would diminish or eliminate the need for hedge accounting offering a conceptually purer, market-driven measure of financial position and changes that have occurred. However, although the AcSB standard provides the opportunity to adopt such an approach, there is little evidence that broad application of fair value reporting will be a path chosen given concern over added volatility in measurement of debt obligations. Generally, outside of debt obligations and investments, PSAB does not believe that governments hold other financial instruments within the scope of the standard where significant variances (other than by way of impairment) necessitate consideration of fair value measurement.

- .043 PSAB believes that until the significant drawbacks that would arise from mandating the reporting of all financial instruments at fair value are resolved, a reporting model that provides for fair value reporting, when necessary, combined with the historical cost-based model for other financial statement items is the best alternative for government reporting.
- .044 In reducing the need to actively designate items upon initial recognition but providing the option to do so, PSAB believes its proposal is highly scalable. In terms of absolute numbers, the majority of governments are small and do not involve themselves in derivative contracts. These governments will only need to determine the fair value of portfolio investments, information readily available. For governments engaged in risk management strategies, the option to designate fair value measurement will be available as an alternative to applying the complexity inherent in hedge accounting. Further, PSAB notes that governmental units who apply the standards of the CICA Handbook – Accounting to the preparation of their entity level financial statements, would be able through choices in the application of those standards to adopt accounting policies that would minimize adjustments required to conform to the PSA Handbook.

### **Gains and losses**

- .045 Frequently the central issue for a standards proposal is when and how to recognize amounts in the statement of operations.
- .046 PSAB proposes the following principles.

#### **Principles**

A gain or loss arising from a change in the fair value of a financial instrument that is not accounted for in accordance with Section B: Hedge Accounting should be recognized in the statement of operations.

For financial instruments carried at amortized cost, a gain or loss is recognized in the statement of operations when the financial asset or financial liability is derecognized or impaired, and through the amortization process. However, for financial assets and financial liabilities that are **hedged items** the accounting for the gain or loss is determined by Section B: Hedge Accounting.

- .047 The proposals do not provide for a category equivalent to available for sale that exists in the AcSB standard. Financial assets designated available for sale are measured at fair value, however gains and losses are not recognized in net income until the item is sold or otherwise derecognized. Instead, the gains and losses are an element of comprehensive income. PSAB concluded that this provision, established to mitigate volatility in reported earnings while maintaining the principle that fair value provides the most relevant basis of measurement was not relevant to financial reporting by governments. In reaching this conclusion, it weighed the qualitative characteristics that define information relevant to financial statement users and which contribute to the reliability of that information. In PSAB's view, the potential for greater use of fair value measurement (hence increased completeness) allowed through the available-for-sale category is not warranted by the potential loss in neutrality and understandability that would occur when gains and losses on assets, otherwise identical, are treated differently in measuring surplus/deficit for the period. PSAB concluded that gains and losses arising on financial instruments carried at fair value are relevant in assessing the stewardship of the resources entrusted to the government and, as such, should be reported in the statement of operations except when hedge accounting directs otherwise.
- .048 PSAB believes that the hedge accounting proposals (see Section B: Hedge Accounting) provides governments with the tools to address volatility in the statement of operations for qualifying hedging relationships. The requirements to qualify for hedge accounting are unchanged from those in FOREIGN CURRENCY TRANSLATION, Hedging of foreign currency items, Section PS 2600. The scope of risks that may be hedged has been broadened. The use of hedge accounting remains optional. In addition, the fair value measurement option (described in paragraphs .36-.39) is available to eliminate or significantly reduce measurement or recognition inconsistencies or to permit measurement at fair value of a group of financial assets, financial liabilities or both subject to management and performance evaluation on a fair value basis in accordance with a documented risk management or investment strategy.

### **Impairment of financial assets**

- .049 Impairment needs to be considered for financial assets that are not subject to remeasurement at fair value. The standard needs to address how frequently this is done and the approach.
- .050 The proposed principle would require that this be considered at each reporting date, applying established standards in the PSA Handbook.

## **Principle**

Financial assets carried at fair value are not subject to assessment for impairment. For financial assets or groups of financial assets carried at amortized cost, a government should assess at each reporting date whether there is any objective evidence of impairment. If any such evidence exists, a government should apply:

- (a) PORTFOLIO INVESTMENTS, Section PS 3040, to assess whether portfolio investments are impaired and to account for any such impairment;
- (b) LOANS RECEIVABLE, Section PS 3050, to assess whether loans receivable are impaired and to account for any such impairment; or
- (c) FINANCIAL STATEMENT PRESENTATION, paragraph PS 1200.049, for all other financial assets including receivables.

- .051 PORTFOLIO INVESTMENTS, Section PS 3040, provides standards that apply in accounting for a loss in value of a portfolio investment that is other than a temporary decline. These standards would continue to apply for portfolio investments not quoted in an active market.
- .052 The disappearance of an active market does not mean that a portfolio investment is necessarily impaired. In such circumstances, unless designated by a government to be carried at fair value, a portfolio investment would no longer qualify as a financial instrument carried at fair value (see Reclassifications, below). As is the case for other portfolio investments not quoted in an active market, conditions indicating possible impairment would be evaluated.
- .053 LOANS RECEIVABLE, Section PS 3050, provides standards that apply where a valuation provision may be required and standards that apply when write-offs are required. Generally it is anticipated that loans receivable will be reported at amortized cost and present standards for valuation provisions or write-offs would apply.

## **Reclassifications**

- .054 Reclassification of a financial instrument may arise for any one of four reasons:
  - (a) a quoted price may no longer be available for a portfolio investment;
  - (b) a quoted price may become available for a portfolio investment when previously there was none;
  - (c) a government may designate<sup>9</sup> an existing item to be a financial instrument carried at fair value; or
  - (d) a government may revoke designation of an item as a financial instrument carried at fair value for any item that no longer qualifies for such a designation.

The standard needs to address the accounting implications of these changes.

- .055 To address these issues, PSAB proposes the following principles.

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<sup>9</sup> Appendix A, paragraph A.07(c) defines requirements that apply.

## Principles

When a quoted price in an active market is no longer available for a portfolio investment, a government should measure the portfolio investment at amortized cost rather than fair value. The most recent quoted price becomes the new cost or amortized cost.

When a quoted price in an active market becomes available for a portfolio investment for which such a price previously was not available, the asset should be remeasured at fair value, and the difference between its carrying amount and fair value should be recognized in the statement of operations.

When a government designates an existing non-derivative financial asset or a non-derivative financial liability as a financial instrument carried at fair value, any difference between its carrying amount and fair value as measured at the date of its designation should be recognized directly in net debt through the statement of changes in net debt. Upon subsequent derecognition of the item, any amount recognized in net debt should be recognized in the statement of operations in addition to any gain or loss arising from a change in fair value occurring during the reporting period.

When a government discontinues designation of a non-derivative financial asset or a non-derivative financial liability as a financial instrument carried at fair value, its carrying value at the date the designation is discontinued becomes its new amortized cost.

- .056 When a quoted price in an active market is no longer available for a portfolio investment, there are two apparent alternatives. Taking the most recent quoted price is preferred, as in the absence of an impairment event, the most recent value at which the asset traded is expected to provide the most relevant available information as to fair value. PSAB rejected the alternative of requiring that amortized cost be restored as it is unlikely to provide superior information as to the present fair value of the asset.
- .057 Consistent with its decision to limit the application of fair value reporting, PSAB does not propose to require governments to employ fair value measurement techniques in reporting portfolio investments where a quoted price in an active market is not available. Consideration was given to expanding requirements to apply fair value measurement to investments and other non-derivatives. This would involve use of valuation techniques, in some cases on an item by item basis. On balance, it was determined that the benefit of the information provided would not outweigh the cost in most circumstances. The fair value measurement option would be available to those governments who manage groups of items and evaluate performance on a fair value basis.
- .058 When a quoted price in an active market becomes available for a portfolio investment for which such a price previously was not available, PSAB believes the principal issue is not whether that price should be used, rather how should any gain or loss on the remeasurement be accounted for. PSAB believes it is appropriate to use the available information to ensure that the measures of net debt and of accumulated surplus/deficit appropriately reflect the value available in the asset. Although there is the potential that a significant change may need to be

accounted for in the period a quoted market price is re-established, PSAB believes that this represents the most appropriate reporting of the events that have occurred. An alternative would be the deferral of some portion of any gain or loss. However, the conceptual framework would not support this treatment. In the event an impairment charge has been recorded, this treatment would not prohibit its reversal. Given that a quoted price in an active market is available, PSAB believes this would provide the most meaningful measure of the value available in the portfolio investment.

- .059 The designation of an existing non-derivative financial asset or non-derivative financial liability poses a more difficult issue. PSAB believes designation of an item carried at amortized cost to fair value measurement should be an action grounded on providing more relevant information to financial statement users. The definition of “financial instruments carried at fair value” specifies the two circumstances considered to fulfill this requirement. As portfolio investments carried in an active market are required to be carried at fair value, such a reclassification is not expected to occur frequently. Nonetheless the accounting must be addressed. Three alternatives were considered:
- (a) remeasuring the item at fair value, recognizing all gains or losses in the statement of operations in the period of reclassification;
  - (b) not adjusting the carrying value of the reclassified item, recognizing only future gains and losses in the statement of operations; and
  - (c) remeasuring the item at fair value, transferring gains or losses to the date of reclassification to net debt for recognition in a future period (when the item is derecognized).

As PSAB’s proposed approach permits designation of previously recognized items when the AcSB standards do not, no direct precedent was available for evaluation.

- .060 In evaluating these three options, PSAB focused on reporting externally determined values and reporting changes in those values that occurred during the period being reported on. First, in terms of reporting the value of an item on the statement of financial position, reporting the item at fair value provides superior information while seeking to avoid mixing bases of measurement when possible. Second, PSAB favoured reporting only those gains and losses in the statement of operations attributable to the period following reclassification. In support of accountability, and given that reclassification is an internal decision, the commingling of gains and losses of prior periods with those of the period being reported on should be avoided.
- .061 Attention must be paid to accounting for gains and losses in the period items are ultimately derecognized in circumstances where items have been reclassified to fair value measurement subsequent to initial recognition. Ensuring accountability requires that all gains and losses are ultimately recognized in the statement of operations, necessitating reversal of any amounts recognized directly in the statement of changes in net debt, as a result of reclassification, in the period the item is derecognized.

- .062 In situations where a government discontinues the designation of a non-derivative financial instrument from being carried at fair value, continuing the established value at the date of the change in designation as the carrying value is viewed as a superior approach as it does not result in an immediate reversal to operations of any gains or losses arising during the period the item was designated for fair value measurement. Reversal of any amount reported as a change in net debt would not occur until the item is derecognized.
- .063 Although the accounting for reclassifications is complex, PSAB believes the proposals are significantly less difficult to apply than those that would arise from a standard providing additional intention-based designations. PSAB believes that the option to apply fair value measurement to items in periods subsequent to their initial recognition enhances the utility of the fair value measurement option, decreasing the need for hedge accounting.

### **Embedded derivatives**

- .064 Contracts containing provisions that cause some of the cash flows to vary in a way similar to a stand-alone derivative present a difficult accounting issue. To protect the integrity of the standard, it is necessary to establish the accounting treatment where derivatives are embedded within what are otherwise non-derivative contracts.
- .065 The following principles are proposed to govern accounting for embedded derivatives.

#### **Principles**

An embedded derivative should be separated from the host contract and accounted for as a derivative if, and only if, all of the following conditions are met:

- (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;
- (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- (c) the hybrid (combined) instrument is not measured at fair value (i.e., derivatives embedded in financial instruments carried at fair value are not separated).

If an embedded derivative is separated, the host contract should be accounted for applying the provisions in these proposals if it is a financial instrument, and in accordance with other appropriate standards if it is not a financial instrument.

If a contract contains one or more embedded derivatives, a government may designate the entire hybrid (combined) contract as a financial instrument carried at fair value unless the embedded derivative provisions are superficial to the contract.

If a government is required to separate an embedded derivative from its host contract, but is unable to measure the embedded derivative separately either at acquisition or at a subsequent financial reporting date, it should treat the entire hybrid (combined) contract as a financial instrument carried at fair value.

- .066 An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract — with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract. A derivative that is attached to a financial instrument but is contractually transferable independent of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.
- .067 The AcSB and IASB standards both require separate accounting for an embedded derivative not closely related to the host contract. Although complex provisions are required to support this principle, it protects the integrity of the standard. In adopting an approach that is consistent with the AcSB and IASB standards, PSAB believes public sector preparers will benefit from consistency in established practice and in mitigation of GAAP differences on consolidation of governmental units applying the AcSB standard.
- .068 The objective of the provisions is to assess whether a derivative is required to be separated from the host contract. In some circumstances where separation of an embedded derivative is required, it may be easier to recognize and measure the entire contract at fair value. For this reason, consistent with the AcSB and IASB standards, PSAB proposes to allow the entire instrument to be designated as a financial instrument carried at fair value. When an embedded derivative is superficial to the agreement, the option to fair value the entire contract would not be available. PSAB intends that the detailed provision establishing when an embedded derivative is superficial should be common with the IASB standard.

## **Section B: Hedge accounting**

- .069 This section outlines principles for when and how hedge accounting may be applied. The proposals apply principles based on a framework that respects key aspects of PSAB’s conceptual framework and the measurement of all derivatives at fair value communicated in the SOP, “Recognition and Measurement of Derivatives.” Appendix C: Fundamental Principles, summarizes key aspects of this document. Responses indicated broad support for PSAB to develop a hedge accounting standard broader in scope than the existing provisions within FOREIGN CURRENCY TRANSLATION, Section PS 2600.
- .070 Hedge accounting is optional. Measurement of items denominated in foreign currencies at current rates and portfolio investments quoted in an active market at fair value may serve to reduce the need for hedge accounting. Further, governments may determine that the option to designate<sup>10</sup> other financial assets

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<sup>10</sup> See paragraphs .35-.38.

and financial liabilities or groups of such items for fair value measurement will further reduce the frequency hedge accounting needs to be applied.

### **Conditions for hedge accounting**

- .071 FOREIGN CURRENCY TRANSLATION, paragraph PS 2600.06(g), states hedge accounting is a method for recognizing the gains, losses, revenues and expenses associated with the items in a hedging relationship, such that those gains, losses, revenues and expenses are recognized in operations in the same period when they would otherwise be recognized in different periods. Section PS 2600 makes hedge accounting available subject to specific conditions. These existing conditions have been integrated into these proposals based on the fundamental principle that as special accounting, hedge accounting should only be provided for qualifying items.
- .072 The present requirements of paragraph PS 2600.32 that establish the conditions for hedge accounting are incorporated into the principle set out below.

#### **Principle**

A hedging relationship qualifies for hedge accounting if, and only if, all of the following conditions are met.

- (a) At the inception of the hedge there is formal designation and documentation of the hedging relationship and the government's risk management objective and strategy for undertaking the hedge. That documentation should include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the government will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk.
- (b) The hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistent with the originally documented risk management strategy for that particular hedging relationship.
- (c) For cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect surplus or deficit in the period.
- (d) Hedge effectiveness can be reliably measured, (i.e., the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured).
- (e) The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which the hedge was designated.

- .073 Definitions for a hedged item and a hedging instrument allow a broader scope of hedging relationships. The principle reflects these changes and will eliminate the requirement to document of the method for recognizing in operations the gains, losses, revenues and expenses as specific recognition standards make these

provisions redundant. Based on the IASB standards, PSAB's conditions for hedge accounting will result in conditions in common with the AcSB standard.

- .074 Hedge accounting modifies the fundamental recognition and measurement requirements. As such, it is critical to ensure that hedging instruments are highly effective. In order for a hedging instrument to be highly effective, it must achieve a high correlation in offsetting changes in fair value or offsetting cash flows attributable to the risk being hedged. PSAB believes, in principle, that gains and losses on derivatives should be reflected in the statement of operations unless application of the hedge accounting framework permits otherwise. Thus, the principles limit use of hedge accounting to situations where hedge effectiveness is reliably measurable and any ineffectiveness immediately recognized.

### **Types of hedging relationships**

- .075 PSAB adopts two of the three basic types of hedging relationships provided in the AcSB and IASB standards.
- .076 The proposed principle requires that surplus or deficit in the period be affected for hedge accounting to apply.

#### **Principle**

Hedging relationships are of two types:

- (a) Fair value hedge — a hedge of the exposure to changes in fair value of:
  - (i) a recognized asset or liability or an unrecognized firm commitment; or
  - (ii) an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect surplus or deficit in the period.
- (b) Cash flow hedge — a hedge of the exposure to variability in cash flows that:
  - (i) is attributable to a particular risk associated with a recognized asset or liability (such as all or some future interest payments on variable rate debt), or a highly probable forecast transaction, or a foreign currency risk in an unrecognized firm commitment; and
  - (ii) could affect surplus or deficit in the period.

- .077 Defining key terms and hedge accounting methods that are common to the AcSB and IASB standards benefits governments as it will minimize GAAP differences on consolidation of governmental units. Knowledgeable readers of financial statements will benefit as many will already be familiar with hedge accounting as it is applied by private sector organizations.
- .078 The elements that may comprise a fair value hedge are in common with the AcSB and IASB standards.
- .079 The IASB paragraph describing a cash flow hedge does not specifically include reference to foreign currency risk on unrecognized firm commitments. This provision appears in a separate paragraph. Given that the hedging of foreign currency risks on unrecognized future commitments is a common risk

- management strategy of Canadian governments, PSAB favours including this specific provision to parallel the definition used in the AcSB standard. It has been adopted in part to avoid unnecessary misunderstandings as to the scope of permitted hedging relationships. On a separate issue, in basing its definition on the IASB definition, PSAB included the words highly probable in describing forecast transactions that qualify for cash flow hedging. This wording, used by the IASB is a concept required by AcSB but not reflected in its definition.
- .080 PSAB excluded hedging of a net investment in a self-sustaining foreign operation from the types of permitted hedges. FOREIGN CURRENCY TRANSLATION, Section PS 2600, excludes translation of the financial statements of foreign operations from its scope. In researching these proposals, PSAB concluded that foreign operations of government are typically financially or operationally interdependent with the government. Although some agencies have features that suggest they may be self-sustaining, they generally borrow based on a sovereign guarantee and therefore would not qualify. PSAB concluded that the exposure to exchange rate changes for the foreign operations of governments is similar to the exposure that would exist had the transactions and activities been undertaken by the government itself.
- .081 PSAB considered responses to the request for information issued by staff on the topic of hedge accounting by government. To the extent issues raised pertained to principles in the application of hedge accounting, aspects have been incorporated or reasons given when positions considered were not adopted. In some cases, provisions to permit specific techniques were advocated. Examination at a more detailed level will come with development of a detailed standards proposal. Discussion of matters considered to date is detailed in the paragraphs that follow.
- .082 Specific to hedge methodologies involving groups of items (macro hedging), PSAB proposes the detailed supporting provisions of the draft standard will permit the designation of:
- (a) groups of similar assets or similar liabilities as the hedged item; and,
  - (b) two or more derivatives or portions of them as the hedging instrument.
- It is not intended that groups comprised of assets and liabilities, would qualify as hedged items or hedging instruments. Consistent with a decision reached by the AcSB, these complex provisions are excluded from this proposal. PSAB understands that they are principally of concern to financial institutions. Further study of their application in use is warranted prior to implementation in Canada. Readers interested in further details are encouraged to review the “Hedges” Background Information and Basis for Conclusions document, paragraphs 33-35,<sup>11</sup> issued by the AcSB. The fair value measurement option supports measurement and reporting of groups of financial assets, financial liabilities or both, in a manner consistent with how they are managed. PSAB believes that in proposing to permit reclassification of items subsequent to initial recognition, a provision not available in the AcSB standard, it is increasing the utility of the fair value measurement option as a viable alternative to address the concerns raised.

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<sup>11</sup> Available in the electronic version of the CICA Handbook – Accounting.

- .083 A hedging relationship may be structured with the object of hedging only a portion of the hedged risk. The definition provides for this. Documentation will need to clearly specify the portion of the risk being hedged in order to support the need to account for any ineffectiveness in a hedging relationship.
- .084 Similar to the IAS and AcSB standards, provisions will be incorporated permitting a percentage of the notional amount of a hedging instrument be designated as the hedging instrument in a hedging relationship.
- .085 Provisions will be included to permit hedging for a period less than the term to maturity of either the hedged item or the hedging instrument (a partial-term hedge), provided the term of the relationship is designated on inception and all of the other conditions for hedge accounting are satisfied. However, PSAB cautions that it is generally difficult to achieve an effective partial-term fair value hedge, particularly when the hedging instrument has a term to maturity significantly shorter than that of the hedged item.
- .086 PSAB was not swayed by arguments that financial reporting by governments involving derivatives or their use in hedging relationships should be fundamentally different from requirements for businesses and not-for-profit organizations. The assertion that governments are distinct because they are not issuers of derivatives, nor actively speculate on market outcomes does not hold, as in the majority of cases, businesses and not-for-profit organizations do not engage in such activities. Although the information needs of financial statement users may vary, users deserve reporting that is complete in showing the impact derivatives have on financial position. PSAB believes an understanding of derivatives and their use in hedging relationships will be enhanced by adopting an approach that is based on the consistent principles of recognizing derivatives at fair value and immediate recognition of ineffectiveness arising from their use in hedging relationships.
- .087 The proposals provide governments with a hedge accounting standard that is broad in scope. The present standard addresses only the hedging of identified foreign currency risk exposures. The proposed standard addresses hedging of firm commitments and highly probable forecast transactions.

### **Fair value hedges**

- .088 Both elements in a fair value hedge, the hedging instrument (generally a derivative but in hedging fluctuations in foreign currencies, non-derivative assets and non-derivative liabilities can be used), and the hedged item (a non-derivative asset, non-derivative liability or firm commitment<sup>12</sup>) are recognized items in financial statements. The standard must address how gains and losses that arise on remeasurement are treated for each element in the fair value hedging relationship.

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<sup>12</sup> By including firm commitments within the scope of permitted fair value hedging relationships, gains or losses are by consequence reported as financial statement items.

- .089 Gains and losses arising on items that are part of a fair value hedge would be accounted for according to the following principle.

**Principle**

If a fair value hedge meets the conditions for hedge accounting<sup>13</sup> during the period, it should be accounted for as follows:

- (a) the gain or loss from remeasuring the hedging instrument at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount measured in accordance with FOREIGN CURRENCY TRANSLATION, Section PS 2600, (for a non-derivative hedging instrument) should be recognized in the statement of operations; and
- (b) the gain or loss on the hedged item attributable to the hedged risk should adjust the carrying amount of the hedged item and be recognized in the statement of operations. This applies if the hedged item is otherwise measured at cost or amortized cost.

- .090 A non-derivative financial instrument may be designated as a hedging instrument to hedge changes in value arising from the foreign currency component of a hedged item. As such, effectiveness would be judged in relation to changes in its carrying value arising from foreign currency translation. To illustrate, if a government designated a US\$ denominated loan receivable as the hedging instrument, it would remeasure that instrument based on FOREIGN CURRENCY TRANSLATION, Section PS 2600, and report the gain or loss arising from the change in the exchange rate in operations during the reporting period.
- .091 In terms of the hedged item, its carrying value is only modified in respect of the hedged risk. Building on the illustration in the preceding paragraph, if the hedged item was an amount owing to a supplier expressed in US\$, the payable balance would not be remeasured for changes in interest rate or credit risks but only in respect of the hedged risk, being the fluctuation in the foreign currency rate. The proposal would not result in the need to determine the gain or loss on the hedged item other than for the hedged risk.
- .092 Gains and losses for the hedging instrument and hedged items would be determined independently and reported in the statement of operations. The result is that ineffectiveness is recognized automatically.
- .093 A hedge of exposure to a change in the fair value of an unrecognized firm commitment is within the scope of permitted fair value hedging relationships. This parallels the scope permitted by the AcSB and IASB standards ensuring that consolidation adjustments would not be required for governmental units applying the CICA Handbook – Accounting. However as an unrecognized firm commitment is not recognized in the financial statements, PSAB proposes to remedy this by requiring the change in the fair value of the firm commitment be reported as an asset or liability equivalent to the gain or loss reported in

<sup>13</sup> See the principle detailed in paragraph .72.

operations. This treatment conforms with the AcSB and IASB standards. Although the recognition of such amounts would depart from the conceptual framework, this approach is proposed to avoid a GAAP difference.

- .094 Where it is established that the critical terms of the hedging instrument and the hedged item are the same, for certain types of hedges, the AcSB standard provides that an entity can conclude that changes in the fair value attributable to the risk being hedged are expected to offset completely at inception and throughout the term. For qualifying hedges, a presumption of no ineffectiveness is permitted. PSAB believes that it is desirable that its standards proposal provide governments with equivalent treatment in circumstances that meet the requirements set out in HEDGES, CICA HANDBOOK – ACCOUNTING paragraphs 3865.30-.32. Although these provisions depart from the IASB standard, PSAB believes provisions that permit governments to assume there is no ineffectiveness in certain hedging relationships are important in easing the burden of compliance with hedge accounting requirements and in limiting GAAP differences with the AcSB standard.
- .095 The approach to fair value hedge accounting set out in the preceding paragraphs achieves the objectives of recognizing derivatives at fair value. As well, it improves the existing standard by setting out specifically how gains and losses on the hedged item and hedging instrument are accounted for. It serves to mitigate financial statement volatility that may arise from remeasurement of the hedged item by requiring that the remeasurement only reflect those gains and losses that arise from the hedged risk. The proposal reports ineffectiveness in operations as it arises by independently measuring and reporting gains and losses on both elements in the hedging relationship. PSAB has not identified any matter specific to the objectives of government financial reporting that would require an approach to fair value hedge accounting at variance with that adopted in the AcSB standard. Accordingly, it believes governments would be best served by adopting an approach for fair value hedge accounting consistent with the AcSB standard and it did not extensively examine other alternatives.

### **Cash flow hedges**

- .096 The second category of hedges is cash flow hedges. These are hedging relationships established to hedge exposure to variability in cash flows associated with a recognized asset or liability, highly probable forecast transaction or a foreign currency risk in an unrecognized firm commitment.

- .097 Gains and losses arising on the hedging instrument in a cash flow hedge would be accounted for in accordance with the following principle.

**Principle**

If a cash flow hedge meets the conditions for hedge accounting<sup>14</sup> during the period, it should be accounted for as follows:

- (a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge should be recognized directly in net debt through the statement of changes in net debt; and
- (b) the ineffective portion of the gain or loss on the hedging instrument should be recognized in the statement of operations.

- .098 The hedging instrument is measured at fair value (except a non-derivative hedging instrument which is measured at the exchange rate in effect on the financial reporting date) consistent with the approach adopted for fair value hedges. However, as the hedged item is the variability in future cash flows, an item not directly recognized in financial statements, the portion of the change in the value of the hedging instrument that is effective must be determined and it is this value that is recorded directly as a change in net debt. Consistent with the principle that derivatives are assets and liabilities and should be measured at fair value, the measurement of net debt must reflect changes in a derivative's value. Hedge accounting simply respects the designation of the derivative by a government for the purpose of hedging. In achieving this end, the gain or loss is excluded from the statement of operations until the future cash flows associated with the hedge occur.
- .099 The gain or loss represented in the effective portion of the hedging instrument is characterized in the AcSB standard as giving rise to other comprehensive income, although the standard does not require that it be labeled as such. PSAB does not propose to use the descriptor "other comprehensive income" for amounts posted to the change in net debt as it considers this unnecessary. It is unnecessary given the limited situations where gains or losses would be recorded directly as a change in net debt. The more precise descriptor "gain/loss on cash flow hedging instruments", is proposed. PSAB believes that such amounts, supported by descriptive explanations in notes to the financial statements will be understood by readers. In adopting this approach, PSAB believes the potential for misunderstandings to arise as to the appropriate measure of surplus/deficit for the period is significantly mitigated (see Appendix E: Illustrative Example — Presentation of a Cash Flow Hedge).
- .100 An alternative would be to require that all gains and losses (including those on cash flow hedging instruments) be reported in the statement of operations. This view merits consideration as it aligns with concepts underpinning the reporting model anticipating changes in assets and liabilities are reported in the statement of

<sup>14</sup> See the principle detailed in paragraph .72.

- operations in the period the change occurs. Appendix G: Reporting of Gains and Losses on Cash Flow Hedging Instruments, details the key arguments in favour of this position, the reasons it was not adopted, together with a supporting illustration.
- .101 Any ineffectiveness in the hedging instrument is required to be recognized immediately in the statement of operations. At a minimum, a government will be required to measure effectiveness at each interval it prepares summary financial statements, applying the technique documented at the outset of the hedging relationship. Consistent with FOREIGN CURRENCY TRANSLATION, Section PS 2600, PSAB does not propose to detail how effectiveness is to be tested or the range of effectiveness that satisfies the requirement that a hedging relationship be highly effective. The method for assessing hedge effectiveness and whether the hedging instrument is highly effective in achieving its objective is best determined by the government and may depend on its risk management strategy.
- .102 Providing specific conditions are met, a government may conclude that changes in the cash flows attributable to the risk being hedged may be expected to offset completely at inception and throughout the term of the hedging relationship. For the reasons outlined in paragraph .94, it is proposed an assumption of no ineffectiveness be permitted in accounting for hedging instruments that qualify as matching the critical terms of the hedged item. In such situations, requirements to determine and account for ineffectiveness would be substantially diminished.
- .103 The approach to cash flow hedge accounting set out in the preceding paragraphs achieves the objectives of recognizing derivatives at fair value. It improves the existing standard by detailing specific accounting requirements for recognition of gains and losses on the hedging instrument. It mitigates volatility in the reporting of the annual surplus/deficit by requiring changes in the hedging instrument, to the extent they are determined to be effective in offsetting changes in future cash flows attributable to the hedged risk, to be excluded from the statement of operations. An alternative to the proposal is to continue to account for derivatives in cash flow hedging relationships “off-balance sheet”, by simply not recognizing them. PSAB has not adopted this approach as it violates principles adopted that derivatives are assets or liabilities and should be measured at fair value.

### **Anticipated transactions**

- .104 Governments may hedge exposures specific to transactions that are anticipated but have yet to give rise to a recognized asset or liability. The scope of the hedging relationships provided for in these proposals, includes both firm commitments and forecast transactions. An accounting issue arising from these provisions is accounting for gains and losses when an asset or liability is ultimately realized.
- .105 The following principles propose accounting for the gains and losses on the hedging instrument when the item recognized is:
- (a) a financial asset or financial liability;
  - (b) a non-financial asset or non-financial liability; and

- (c) not reported on the statement of financial position (such would be the case when the anticipated transaction is a sale, or the purchase of an intangible asset or a service).

### **Principles**

If a hedge of a forecast transaction subsequently results in the recognition of a financial asset or a financial liability, the associated gains or losses that were recognized directly in net debt in accordance with paragraph .97 should be reclassified into the statement of operations in the same period or periods during which the asset acquired or liability assumed affects surplus/deficit for the period (such as in the periods that interest income or interest expense is recognized). However, if a government expects that all or a portion of a loss recognized directly in net debt will not be recovered in one or more future periods, it should reclassify into the statement of operations the amount that is not expected to be recovered.

If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or a non-financial liability, or a forecast transaction for a non-financial asset or non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, then the government should adopt (a) or (b) below:

- (a) It reclassifies the associated gains and losses that were recognized directly in net debt in accordance with paragraph .97 into the statement of operations in the same period or periods during which the asset acquired or liability assumed affects surplus or deficit in the period (such as in the period that depreciation expense is recognized). However, if a government expects that all or a portion of a loss recognized directly in net debt will not be recovered in one or more future periods, it should reclassify into the statement of operations the amount that is not expected to be recovered.
- (b) It removes the associated gains and losses that were recognized directly in net debt in accordance with paragraph .97, and includes them in the initial cost or other carrying amount of the asset or liability.

A government should adopt either (a) or (b) as its accounting policy and should apply it consistently to all hedges described in the preceding paragraph.

For cash flow hedges other than those covered by these two principles, amounts that had been recognized directly in net debt should be recognized in the statement of operations in the same period or periods during which the hedged forecast transaction affects surplus or deficit for the period (for example, when a forecast sale occurs).

- .106 The proposal to permit alternative treatments when recognizing non-financial assets and non-financial liabilities is consistent with the AcSB and IASB standards. Allowing a government to include the gains or losses from the hedging activity in the initial cost avoids the potential need to separately amortize the gain or loss over many years (such as when a long-lived tangible capital asset is acquired).

## Discontinuing hedge accounting

- .107 A government is required to discontinue hedge accounting when either the hedging instrument or the hedged item ceases to exist, designation of the hedging relationship is terminated, the hedging relationship ceases to be effective, or when it becomes apparent that the anticipated transaction will not occur. Should any of these issues arise, the standard needs to address accounting for accumulated gains or losses on the hedging instrument.
- .108 When a fair value hedge is discontinued, it is accounted for as set out below.

### Principle

A government should discontinue, prospectively,<sup>15</sup> fair value hedge accounting as specified in paragraph .89 if:

- (a) the hedging instrument expires or is sold, terminated or exercised (for this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the government's documented hedging strategy);
- (b) the hedge no longer meets the conditions for hedge accounting; or
- (c) the government revokes the designation.

Any adjustment arising from paragraph .89(b) to the carrying amount of a hedged financial instrument for which the effective interest method is used should be amortized to the statement of operations. Amortization may begin as soon as an adjustment exists and should begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged. The adjustment is based on a recalculated effective interest rate at the date amortization begins. The adjustment should be fully amortized by maturity of the financial instrument.

- .109 When a cash flow hedge is discontinued, it is accounted for as set out below.

### Principle

In any of the following circumstances a government should discontinue, prospectively,<sup>16</sup> cash flow hedge accounting as specified in paragraphs .97 and .105:

- (a) The hedging instrument expires or is sold, terminated or exercised (for this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the government's documented hedging strategy). In this case, the cumulative gain or loss on the hedging instrument that remains recognized

<sup>15</sup> In using the term "prospectively", PSAB intends that the discontinuance of the hedging relationship would not result in any restatement of items accounted for in accordance with the hedge accounting provisions when reporting on those items in periods subsequent to the discontinuance of hedge accounting.

<sup>16</sup> See previous footnote regarding the term "prospectively".

directly in net debt from the period when the hedge was effective (see paragraph .97(a)) should remain recognized in net debt until the forecast transaction occurs. When the transaction occurs, the accounting described in the preceding paragraphs above applies.

- (b) The hedge no longer meets the conditions for hedge accounting.<sup>17</sup> In this case, the cumulative gain or loss on the hedging instrument that remains recognized in net debt from the period when the hedge was effective (see paragraph .97 (a)) should remain in net debt until the forecast transaction occurs. When the transaction occurs, paragraph .105 determines the accounting for the cumulative gain or loss.
- (c) The forecast transaction is no longer expected to occur, in which case any related cumulative gain or loss on the hedging instrument that remains recognized directly in net debt from the period when the hedge was effective (see paragraph .97(a)) should be recognized in surplus or deficit for the period. A forecast transaction that is no longer highly probable<sup>18</sup> may still be expected to occur.
- (d) The government revokes the designation. For hedges of a forecast transaction, the cumulative gain or loss on the hedging instrument that remains recognized directly in net debt from the period when the hedge was effective (see paragraph .97(a)) should remain recognized in net debt until the forecast transaction occurs or is no longer expected to occur. When the transaction occurs, paragraph .105 determines the accounting for the cumulative gain or loss. If the transaction is no longer expected to occur, the cumulative gain or loss that had been recognized directly in net debt should be recognized in the statement of operations.

.110 The proposed accounting for a discontinued cash flow hedge involving a forecast transaction causes the gain or loss to be retained until the object of the forecast hedge is resolved. This treatment is consistent with the intent in establishing the hedge and is intended to block selective recognition of gains or losses. Only when a forecast transaction is not expected to occur, a situation that is significantly less likely than highly probable, would any cumulative gain or loss be recognized in the statement of operations. PSAB believes these provisions, based on the IASB standard and convergent with the AcSB standards can be applied by governments and do not warrant development of an alternative approach.

### **Section C: Disclosure and presentation**

.111 The principles in this section compliment the principles for recognizing, measuring and presenting financial assets and financial liabilities detailed in the preceding sections of this SOP. The proposed principles are based on the International Financial Reporting Standard IFRS 7, “Financial Instruments: Disclosures,” issued by the IASB. The AcSB recently approved FINANCIAL

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<sup>17</sup> See the principle detailed in paragraph .72.

<sup>18</sup> For cash flow hedges, a forecast transaction that is the subject of hedge accounting must be highly probable and must present an exposure to variations in cash flows that could ultimately affect surplus or deficit in the period.

INSTRUMENTS — DISCLOSURES, CICA HANDBOOK – ACCOUNTING Section 3862, based on IFRS 7. These standards enable user evaluation of:

- (a) the significance of financial instruments to the government’s financial position and the changes in its financial position in the accounting period; and
- (b) the nature and extent of risks arising from financial instruments to which the government is exposed during the period and at the financial reporting date, and how the government manages those risks.

.112 These proposals also apply to contracts to buy or sell a non-financial item within the scope outlined in Appendix B: Scope.

.113 When these proposals require disclosures by class of financial instrument, a government should group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. A government should provide sufficient information to permit reconciliation to the line items presented in the statement of financial position.

### **Significance of financial instruments to a government’s financial position and changes in its financial position**

.114 Financial statement users require supporting information identifying designations made by a government that significantly impact the reported financial position or changes in that financial position during the period. Generally, this arises when governments designate items to be financial instruments carried at fair value, or for items that are part of a hedging relationship.

.115 The following principles set out the objective of the disclosures.

#### **Principles**

A government should disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and changes in its financial position.

A government that uses hedge accounting should disclose information that enables users of the financial statements to understand the effect of hedge accounting on the financial statements.

In order to understand the nature and extent of hedge accounting, users require disclosure in financial statements of:

- (a) the types of hedges in force during the period;
- (b) hedging instruments being employed;
- (c) objectives for holding or issuing those items;
- (d) the context needed to understand those objectives; and
- (e) strategies for achieving those objectives.

- .116 The proposed requirements to enable these principles are outlined in Appendix F: Disclosures. PSAB believes the users of government financial statements and private sector financial statements share similar needs in relation to understanding the significance of financial instruments and the hedge accounting being employed. For this reason, PSAB based its proposals on requirements adopted in the IASB standard and recently approved AcSB standards. Generally where differences arise, it is because the PSAB proposals streamline the measurement options. In many cases, this decision serves to reduce the extent of disclosures that will be required.
- .117 Governments would not be required to disclose an estimate of fair value for items measured at cost or amortized cost. Rather, the disclosure requirements will focus on providing users with information as to the impact of a decision made to designate an item to be carried at fair value that would otherwise be carried at cost or amortized cost.

### **Nature and extent of risks arising from financial instruments**

- .118 Financial instruments typically expose governments to credit risk, liquidity risk and market risk. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk. Disclosures are needed to assist users in understanding the nature and extent of these risks.
- .119 PSAB proposes the following principle.

#### **Principle**

A government should disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the government is exposed at the reporting date.

- .120 This principle would be served by requiring disclosures in respect of qualitative and quantitative aspects of risks. The qualitative aspects would include disclosure of exposures to risk and how they arise; objectives, policies and processes for managing the risks; and the methods used to measure the risk. Disclosure would include any changes in these factors from the previous period. For each type of risk arising from financial instruments, disclosure would be required of summary quantitative data about exposure to that risk at the reporting date, and other information describing credit risk, liquidity risk, and market risk. For market risk, a sensitivity analysis would be an integral component.
- .121 In proposing to align disclosures with those adopted by the IAS and the AcSB standards, PSAB believes users would benefit from information and commentary on risk and its management that is consistent with established practice. More specific details of requirements to enable this principle will be included in the exposure of the draft standard.

## Offsetting of a financial asset and a financial liability

- .122 Offsetting a recognized financial asset and a recognized financial liability and presenting the net amount differs from ceasing to recognize a financial asset or a financial liability. While offsetting does not give rise to recognition of a gain or a loss, ceasing to recognize a financial instrument not only results in the removal of the previously recognized item from a statement of financial position, but may also result in recognition of a gain or loss.
- .123 PSAB proposes the following principle.

### Principle

A financial asset and a financial liability should be offset and the net amount reported in the statement of financial position when, and only when, a government:

- (a) currently has a legally enforceable right to set off the recognized amounts; and
- (b) intends to settle on a net basis, or to realize the asset and settle the liability simultaneously.

- .124 This proposal requires the presentation of financial assets and financial liabilities on a net basis when this reflects a government's expected future cash flows from settling two or more separate financial instruments. When a government has the right to receive or pay a single net amount and intends to do so, it has, in effect, only a single financial asset or financial liability. In other circumstances, financial assets and financial liabilities are presented separately from each other consistent with their characteristics as resources or obligations of the government.
- .125 A right of set-off is a debtor's legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor. In unusual circumstances, a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor, provided that there is an agreement among the three parties that clearly establishes the debtor's right of set-off. Since the right of set-off is a legal right, the conditions supporting the right may vary from one legal jurisdiction to another, and care must be taken to establish which laws apply to the relationships between the parties.
- .126 The existence of an enforceable right to set off a financial asset and a financial liability affects the rights and obligations associated with a financial asset and a financial liability, and may affect significantly a government's exposure to credit and liquidity risk. However, the existence of the right, by itself, is not a sufficient basis for offsetting. In the absence of an intention to exercise the right or to settle simultaneously, the amount and timing of a government's future cash flows are not affected. When a government does intend to exercise the right or to settle simultaneously, presentation of the asset and liability on a net basis reflects more appropriately the amount and timing of the expected future cash flows as well as the risks to which those cash flows are exposed. An intention by one or both

parties to settle on a net basis without the legal right to do so is not sufficient to justify offsetting since the rights and obligations associated with the individual financial asset and financial liability remain unaltered.

- .127 A key implication for governments applying FOREIGN CURRENCY TRANSLATION, Section PS 2600, is that these proposals do not provide special treatment for so-called synthetic instruments, which are groups of separate financial instruments acquired and held to emulate the characteristics of another instrument. For example, floating rate long-term debt combined with an interest rate swap that involves receiving floating payments and making fixed payments synthesizes a fixed rate long-term debt.
- .128 Synthetic instrument accounting violates the principle of measuring derivatives at fair value and results in netting assets against liabilities, usually without the legally enforceable set-off right and intent to settle the two instruments simultaneously. Each financial instrument is exposed to risks that may differ from the risks to which other financial instruments are exposed. Accordingly, when one financial instrument in a synthetic instrument is an asset and another is a liability, they are not offset and presented on a government's balance sheet on a net basis unless they meet the criteria for offsetting set out in the proposed principle. The principle adopted is in common with the AcSB and IASB standards.
- .129 An alternative would be to continue synthetic instrument accounting, evaluating conditions to guide in its application. Given that PSAB's present standard permits its use and given widespread application by governments, consideration was given to this alternative. Appendix H: Synthetic Instrument Accounting, details the key arguments in favour of synthetic instrument accounting, the reasons it was not adopted, together with a supporting illustration.

## APPENDIX A

### DEFINED TERMS

The following terms are used in this document with the meanings specified. Supporting discussion appears later in this section.

#### Defining a financial instrument and a derivative

- A.01 A **financial instrument** is any contract that gives rise to a financial asset of one party and a financial liability or equity instrument of another party.
- A.02 A **financial asset** is an asset that could be used to discharge existing liabilities or finance future operations and is not for consumption in the normal course of operations.
- A.03 A **financial liability** is any liability that is a contractual obligation:
- (a) to deliver cash or another financial asset to another party; or
  - (b) to exchange financial instruments with another party under conditions that are potentially unfavourable to the government.
- A.04 An **equity instrument** is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.
- A.05 A **derivative** is a financial instrument or other contract within the scope<sup>1</sup> of these proposals with all three of the following characteristics:
- (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or other variable (sometimes called the “underlying”), provided in the case of a non-financial variable that the variable is not specific to a party to the contract;
  - (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
  - (c) it is settled at a future date.

#### Definitions relating to recognition and measurement

- A.06 **Amortized cost of a financial asset or financial liability** is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortization using the effective interest method of any difference between that initial amount and the

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<sup>1</sup> Contracts to buy or sell a non-financial item with features of derivatives (for example, settled net in cash) would be within the scope of the standard unless entered into in accordance with the government’s expected purchase, sale or usage requirements. This is consistent with the definition of derivative in the CICA Handbook – Accounting. For further details on the proposed scope, see Appendix B.

maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.

- A.07 **Financial instruments carried at fair value** are financial assets or financial liabilities with gains and losses recognized in the statement of operations. This category applies to financial assets or financial liabilities that are:
- (a) derivatives;
  - (b) portfolio investments quoted in an active market; or
  - (c) items designated by the government to be carried at fair value. A government may only designate all or a portion of a non-derivative financial asset or non-derivative financial liability when permitted by provisions applicable to embedded derivative contracts<sup>2</sup> or when doing so results in more relevant information, because either:
    - (i) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an “accounting mismatch”) that would otherwise arise from measuring assets or liabilities or recognizing the gains or losses on them on different bases; or
    - (ii) a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the government’s key management personnel (for example, the government’s deputy minister of finance or chief financial officer).
- A.08 **Portfolio investments quoted in an active market** are investments in organizations that do not form part of the government reporting entity and are actively traded in a recognized market. A portfolio investment is regarded as quoted in an active market when prices are readily and regularly available from an exchange, broker, industry group, pricing service or regulatory agency, and those prices reflect actual and regularly occurring transactions on an arm’s length basis. Such investments are normally bonds or equity instruments. Portfolio investments do not include:
- (a) cash and cash equivalents;
  - (b) investments in government partnerships, including government business partnerships, as defined in GOVERNMENT PARTNERSHIPS, Section PS 3060;
  - (c) loans receivable, as defined in LOANS RECEIVABLE, Section PS 3050.
- A.09 The **effective interest method** is a method of calculating the amortized cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the

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<sup>2</sup> A provision is proposed to allow governments to designate an entire contract for measurement at fair value if it contains one or more embedded derivatives unless:

- (a) the embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract; or
- (b) it is clear with little or no analysis when a similar hybrid (combined) instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortized cost.

relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability.

When calculating the effective interest rate, a government should estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but should not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the government should use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

- A.10 **Derecognition** is the removal of a previously recognized financial asset or financial liability from a government's statement of financial position.
- A.11 **Fair value** is the amount of consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act.
- A.12 **Transaction costs** are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the government had not acquired, issued or disposed of the financial instrument.

### Definitions relating to hedge accounting

- A.13 A **hedged item** is an asset, liability, firm commitment, or a highly probable forecast transaction that exposes the government to risk of changes in fair value or future cash flows and is designated as being hedged.
- A.14 A **hedging instrument** is a designated derivative or, for a hedge of the risk of changes in foreign currency exchange rates only, a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item.
- A.15 **Hedge effectiveness** is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.
- A.16 A **firm commitment** is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.
- A.17 A **forecast transaction** is an uncommitted but anticipated future transaction.

## Supporting discussion definitions

### A. Defining a financial instrument and a derivative

- A.18 Governments consolidate entities that are implementing the AcSB standards for their entity level reporting. Adopting definitions consistent with the AcSB standards serves to mitigate the potential for real or perceived differences when these entities are consolidated.
- A.19 A financial asset is defined only for the purposes of the financial instruments standards within the CICA Handbook – Accounting. This contrasts with the PSA Handbook where the definition of a financial asset is integral to the reporting model and the measurement of net debt. Financial asset as defined in the PSA Handbook is broader in its scope, including financial claims, certain inventories and items for sale. Although these items will remain within the scope of what PSAB defines as a financial asset, these proposals do not change how these items are measured.
- A.20 FINANCIAL INSTRUMENTS — RECOGNITION AND MEASUREMENT, CICA HANDBOOK – ACCOUNTING paragraph 3855.19(b), provides the following definition:  
“A financial asset is any asset that is:  
cash;  
(i) a contractual right to receive cash or another financial asset from another party;  
(ii) a contractual right to exchange financial instruments with another party under conditions that are potentially favourable to the entity; or  
(iii) an equity instrument of another entity.”  
The definition in the IASB standard includes these same elements.
- A.21 FINANCIAL STATEMENT CONCEPTS, paragraph PS 1000.39, states:  
“Financial assets are assets that could be used to discharge existing liabilities or finance future operations and are not for consumption in the normal course of operations.”  
The existing definition of a financial asset provided in paragraph PS 1000.39 is sufficient in its scope to include the characteristics of the paragraph 3855.19(b) definition. Indeed, the present PSA Handbook definition of a financial asset is broader in that it would include financial claims, certain inventories and items for sale.
- A.22 To ensure that the definition of a financial asset is not misinterpreted as being narrower than the definition in Section 3855, an amendment to the supporting paragraph PS 1000.40 is necessary to include “a contractual right to exchange financial instruments with another party under conditions that are potentially favourable to the government”. A further clarifying change is needed to delete clause (d) “a temporary or portfolio investment” substituting in its place “an equity instrument of another entity” which is consistent with Section 3855. Temporary or portfolio investments must take the form of debt or equity and debt instruments are encompassed in paragraph (c) as it presently exists.

- A.23 The proposed amended wording for PS 1000.40 would read:  
A financial asset is any asset that is:
- (a) cash;
  - (b) a realizable asset that is convertible to cash;
  - (c) a contractual right to receive cash or another financial asset from another party;
  - (d) a contractual right to exchange financial instruments with another party under conditions that are potentially favourable to the government;
  - (e) an equity instrument of another entity;
  - (f) an investment in a government business enterprise or government business partnership;
  - (g) a financial claim on an outside organization or individual; or
  - (h) an inventory or item for sale that meets the criteria in FINANCIAL STATEMENT PRESENTATION, paragraph PS 1200.051.
- A.24 Although inventories and assets held for sale are included in PSAB's definition, their accounting is not within the scope of these proposals (see Appendix B: Scope).
- A.25 The PSA Handbook does not presently define financial liability. The definition proposed is consistent with and would be a subset of the liabilities definition as it exists presently in PS 1000. PSAB is proposing a definition in common with the definition in the AcSB and IASB standards.
- A.26 The PSA Handbook does not presently define equity instrument. A definition is required as governments may hold equity instruments of others for their own account. PSAB is proposing a definition in common with the definition in the AcSB and IASB standards.
- A.27 For the definition of derivative, PSAB determined that the three characteristics of derivatives adopted in the definition for the AcSB standard appropriately describe the scope and nature of the contracts being entered into by governments. PSAB did not identify any elements in the contracts being applied by governments that necessitated a change to the definition of derivative.

## **B. Definitions relating to recognition and measurement**

- A.28 Amortized cost of a financial asset or financial liability is the default category for non-derivative financial assets and non-derivative financial liabilities and portfolio investments other than those quoted in an active market. PSAB is proposing a definition in common with the definition in the AcSB and IASB standards. Although the AcSB and IASB standards permit measurement of many financial assets and financial liabilities at amortized cost, it is not the default category in all cases. In proposing a common definition, PSAB believes consolidation issues will be mitigated, despite differences as to when the category applies.
- A.29 Measurement at fair value with gains and losses recognized in the statement of operations is mandatory for all derivatives and portfolio investments quoted in an

- active market. In addition, the fair value measurement option allows designation of non-derivative financial assets and non-derivative financial liabilities into this category in specific circumstances where doing so results in more relevant information. The equivalent category in the AcSB standard is “financial assets and financial liabilities held for trading”, and in the IASB standard it is a “financial asset or financial liability at fair value through profit or loss”.
- A.30 PSAB proposes the category be labelled financial instruments carried at fair value rather than held for trading or financial asset or financial liability at fair value through profit or loss for the following reasons. First, the only category with measurement at fair value in these proposals requires, in all cases, that gains and losses to be reported in the statement of operations. Second, governments are predominantly providers of services and although fair value measurement is applicable in the circumstances outlined, the label held for trading has little resonance. PSAB believes the proposed label is readily understandable.
- A.31 In evaluating the fair value measurement option, PSAB sought to tie its application to situations where more relevant information would result. The provisions incorporated into the proposed definition of financial instruments carried at fair value that permit designation of fair value measurement are based on amendments introduced into IAS 39 made effective for annual periods beginning on or after January 1, 2006. The AcSB standard does not contain an equivalent provision. However, in June 2006 the Office of the Superintendent of Financial Institutions (OSFI) issued accounting Guideline D-10 indicating that OSFI requires institutions regulated by it to adopt the IAS 39 amendment. The definition proposed parallels the IAS 39 amendment.
- A.32 Adoption of the definition portfolio investments traded in an active market would necessitate amending existing provisions of PORTFOLIO INVESTMENTS, Section PS 3040. Portfolio investments not quoted in an active market, would continue to be measured at cost or amortized cost. As outlined in paragraphs .49-.53, an annual assessment for impairment would be required for portfolio investments not quoted in an active market, applying principles in Section PS 3040. TEMPORARY INVESTMENTS, Section PS 3030, would be withdrawn. Cash and cash equivalents are presently defined in FINANCIAL STATEMENT PRESENTATION, paragraphs PS 1200.096-.097. Since PSAB determined that cash equivalents are subject to an insignificant risk of changes in value, no requirement for remeasurement in periods subsequent to initial recognition is proposed.
- A.33 The proposed definition for effective interest method improves the equivalent definition in PORTFOLIO INVESTMENTS, paragraph PS 3040.02(d), by explaining what an effective interest rate represents and the items to be included and excluded in its calculation. PSAB is proposing a definition in common with IASB standard. Although the IASB and the AcSB definitions are equivalent, the AcSB has chosen to place some of the supporting details in an application supplement. In drafting a final standard, PSAB will consider whether additional interpretative details are required, specifically on the subject of fees.

- A.34 The definition of fair value is in common with the current definition in ADDITIONAL AREAS OF CONSOLIDATION, paragraph PS 2510.04(a), TANGIBLE CAPITAL ASSETS, paragraph PS 3150.05(c), and FINANCIAL INSTRUMENTS — RECOGNITION AND MEASUREMENT, CICA HANDBOOK – ACCOUNTING paragraph 3855.19(j).
- A.35 PSAB is proposing a definition for transaction costs that is in common with the definition in the AcSB and IASB standards. Transaction costs include fees and commission paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

**C. Definitions relating to hedge accounting**

- A.36 The definitions relating to hedge accounting are in common with those in the IASB standard.
- A.37 In defining a hedged item, IASB states an anticipated transaction must be highly probable. The AcSB standard includes the requirement that anticipated transactions must be probable. The AcSB definition of a firm commitment is more detailed as it is based on US GAAP. PSAB does not propose varying from the IASB definitions on either account as it believes it would be advantageous to adopt the IASB definition with which Canadian GAAP is expected to converge. Further, PSAB does not believe a significant GAAP difference will arise when these concepts are applied in practice.
- A.38 Definitions of a hedging instrument and a hedged item do not include words used in the AcSB definitions that address using a portion (or percentage) of an item or grouping items. PSAB proposes to include provisions addressing these matters within the supporting text, similar to the approach taken in the IASB standard.

## APPENDIX B

### SCOPE

#### Recognition and measurement of financial instruments

- B.01 These proposals apply to all types of financial instruments except the items listed below:
- (a) Tax receivables.
  - (b) An inventory or asset for sale that meets the criteria in FINANCIAL STATEMENT PRESENTATION, paragraph PS 1200.051.
  - (c) Interests in government organizations that are accounted for in accordance with GOVERNMENT REPORTING ENTITY, Section PS 1300. This includes all organizations controlled by the government.
  - (d) Interests in government partnerships that are accounted for in accordance with GOVERNMENT PARTNERSHIPS, Section PS 3060.
  - (e) Rights and obligations under leases, to which PUBLIC SECTOR GUIDELINE PSG-2, Leased Tangible Capital Assets, applies. However, the scope of this exception would not extend to:
    - (i) requirements to evaluate impairment for the lessor's receivable from the lessee under a direct financing or sales-type lease;
    - (ii) derecognition provisions applicable to the lessee's liability to the lessor under a capital lease; and
    - (iii) derivatives embedded in leases.
  - (f) Employer's rights and obligations for employee future benefits that are accounted for in accordance with RETIREMENT BENEFITS, Section PS 3250, and POST-EMPLOYMENT BENEFITS, COMPENSATED ABSENCES AND TERMINATION BENEFITS, Section PS 3255.
  - (g) Rights and obligations under an insurance contract held or issued by a government.
  - (h) Guarantees.
  - (i) Loan commitments.
- B.02 Contracts to buy or sell inventories or non-financial items that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, would be subject to the requirements of the proposals unless entered into in accordance with the government's expected purchase, sale or usage requirements.
- B.03 The scope of this project does not include development of standards applicable to the recognition and measurement of tax receivables. Development of a detailed standard applicable to the recognition and measurement of tax revenues is the subject of a separate project. Tax receivables are by their nature confiscatory. The AcSB and IASB standards exclude tax receivables and payables from their scope on grounds that they are not balances arising from contracts.

- B.04 The scope of this project does not include measurement of an inventory or asset for sale that meets the criteria in FINANCIAL STATEMENT PRESENTATION, paragraph PS 1200.051. In excluding these items, the existing treatment based on historical cost, is maintained.
- B.05 The scope of this project does not include re-examination of existing standards that apply to interests in government organizations controlled by the government or interests in government partnerships.
- B.06 The scope of this project does not include re-examination of lease accounting except to require that derivatives embedded in lease agreements and financial instruments arising from a lease agreement such as the amount receivable by a lessor or the amount payable by a lessee be accounted for in accordance with the provisions of these proposals.
- B.07 The scope of this project does not include re-examination of measurement of employee future benefit obligations.
- B.08 The scope of the proposals generally excludes rights and obligations arising from insurance contracts, guarantees and loan commitments. However, it is proposed that this exclusion would be limited by provisions that would require contracts be evaluated for embedded derivatives. The accounting for any embedded derivatives would need to be assessed in relation to the provisions applicable to them.

### **Hedge accounting**

- B.09 Hedge accounting, as outlined in Section B: Hedge Accounting, would not apply in certain specific situations as indicated by the following examples:
- (a) Hedge accounting does not apply to investments in government business enterprises or a government's share of a government business partnership. The modified equity method is inconsistent with the concepts underlying hedge accounting because it does not involve periodic recognition of changes in the fair value of an investment or changes in the cash flows from it.
  - (b) Hedge accounting does not apply to an accrued benefit liability or asset for employee future benefits because the balance represents the net amount of several elements with quite different characteristics. The individual elements are exposed to different types of risks, and some may not be exposed to any risk.
  - (c) Hedge accounting does not apply to anticipated acquisitions of governmental units, anticipated acquisitions of government business enterprises except for hedges of foreign currency risk thereon. However, a government may hedge the exposures associated with the anticipated issue of debt used to fund anticipated acquisitions of governmental units or government business enterprises.

- B.10 The situations cited in the preceding paragraph as items that may not form part of a hedging relationship are consistent with an equivalent provision in the AcSB standards.
- B.11 The hedge accounting proposals preclude the use of an item that represents a net of one or more assets and one or more liabilities together as a hedged item or hedging instrument.
- B.12 Only assets, liabilities, firm commitments or highly probable forecast transactions that involve a party external to the government can be designated as hedged items. It follows that hedge accounting can be applied to transactions between governmental units only in the entity financial statements of those governmental units and not in the summary financial statements of the government.

## APPENDIX C

### FUNDAMENTAL PRINCIPLES

- C.01 This Appendix summarizes aspects of the SOP issued in March 2006, “Recognition and Measurement of Derivatives.” The document focused on the defining the terms “financial instrument” and “derivative”, considered the recognition and measurement of derivatives and principles applicable to hedge accounting in relation to PSAB’s conceptual framework.
- C.02 In December 2004, the Accounting Standards Board (AcSB) approved recognition and measurement standards for financial instruments (the AcSB standards<sup>1</sup>). These standards largely converge practice for organizations that apply the CICA Handbook – Accounting with standards issued by the Financial Accounting Standards Board (FASB) in the United States and the International Accounting Standards Board (IASB). PSAB believes it is desirable to build on the considerable effort that has gone into the development of these standards and the international consensus they represent.

#### Derivatives — recognition and measurement

- C.03 Addressing whether derivatives should be recognized in financial statements is a fundamental issue. PSAB evaluated derivatives in relation to the definitions of an asset and a liability as outlined in FINANCIAL STATEMENT CONCEPTS, Section PS 1000. Applying its conceptual framework, it proposes:

##### Principles

Derivatives represent rights and obligations that meet PSAB’s definitions of assets or liabilities and should be reported in financial statements.

Fair value is the only relevant measurement basis for derivatives.

- C.04 Assets are defined in paragraph PS 1000.35 as being “economic resources controlled by a government as a result of past transactions or events and from which future economic benefits may be obtained.”

The supporting paragraph PS 1000.36, elaborates:  
“Assets have three essential characteristics:

<sup>1</sup> For the purposes of this SOP, the “AcSB standards” refer to standards and conforming amendments in the CICA Handbook – Accounting, including:  
COMPREHENSIVE INCOME, Section 1530;  
FINANCIAL INSTRUMENTS — RECOGNITION AND MEASUREMENT, Section 3855;  
FINANCIAL INSTRUMENTS — DISCLOSURE AND PRESENTATION, Section 3861; and  
HEDGES, Section 3865.

- (a) they embody a future benefit that involves a capacity, singly or in combination with other assets, to provide future net cash flows, or to provide goods and services;
- (b) the government can control access to the benefits; and
- (c) the transaction or event giving rise to the government's control of the benefit has already occurred."

C.05 Liabilities are defined in paragraph PS 1000.44 as "present obligations of a government to others arising from past transactions or events, the settlement of which is expected to result in the future sacrifice of economic benefits."

C.06 The supporting paragraph PS 1000.45, elaborates:  
 "Liabilities have three essential characteristics:

- (a) they embody a duty or responsibility to others, leaving a government little or no discretion to avoid settlement of the obligation;
- (b) the duty or responsibility to others entails settlement by future transfer or use of assets, provision of goods or services, or other form of economic settlement at a specified or determinable date, on occurrence of a specified event, or on demand; and
- (c) the transaction or events obligating the government have already occurred."

C.07 Derivatives qualify as assets and liabilities for the following reasons:

- (a) The ability to settle a derivative in a gain position by receiving cash, another financial asset or a non-financial asset is evidence of a future economic benefit and is compelling evidence that the instrument is an asset.
- (b) Similarly, the requirement to pay cash, transfer a financial asset, or a non-financial asset in settlement of a derivative in a loss position is evidence of a duty to sacrifice assets in the future and indicates that the instrument is a liability.
- (c) The transaction or event giving rise to the government's control of the benefit, or conversely obligating the government, occurs upon execution of the contract to acquire the derivative financial instrument.

C.08 Although derivatives have some similar characteristics, derivatives are not contractual obligations as defined in CONTRACTUAL OBLIGATIONS, paragraph PS 3390.03:

"Contractual obligations are obligations of a government to others that will become liabilities in the future when the terms of those contracts or agreements are met."

C.09 The essential difference between a derivative and a contractual obligation as defined by paragraph PS 3390.03 is that in the case of a derivative, the transaction or event giving rise to the government's control of the benefit occurs upon execution of the contract. Compare this to the execution of a purchase order to acquire a piece of equipment, where the liability and asset are established once the other party to the agreement fulfills their obligation, an event under the other party's control.

C.10 The definition of contingent liabilities, provided in CONTINGENT LIABILITIES, paragraph PS 3300.03, does not fit the characteristics of a derivative:

“Contingent liabilities are possible obligations that may result in the future sacrifice of economic benefits arising from existing conditions or situations involving uncertainty. That uncertainty will ultimately be resolved when one or more future events not wholly within the government’s control occurs or fails to occur. Resolution of the uncertainty will confirm the incurrence or non-incurrence of a liability.”

C.11 Derivatives are not contingent liabilities because the binding event is the execution of the contract. Once executed, the parties have a present and binding obligation. There is uncertainty only as to the extent to which there will be a favourable or unfavourable outcome for the parties bound by it.

C.12 Having established that derivatives fall within PSAB’s definitions of assets and liabilities, the next step is to determine whether they should be recognized under PSAB’s full accrual reporting model.

C.13 Paragraph PS 1000.55 provides the following recognition criteria:

- (a) the item has an appropriate basis of measurement, and a reasonable estimate can be made of the amount involved; and
- (b) for an item that involves obtaining or giving up future economic benefits, it is expected that such benefits will be obtained or given up.

Both of these recognition criteria need to be evaluated.

C.14 Fair value has been adopted as the appropriate basis of measurement for derivatives in accounting standards issued by the AcSB, the FASB and the IASB. Arguments for recognizing derivatives at fair value are outlined below:

- (a) Amortized historical cost is not a relevant measure of a derivative because the historical cost of a derivative is often zero.
- (b) Fair values depict the market’s assessment of the present value of the net future cash flows directly or indirectly embodied in all financial instruments, discounted to reflect both current interest rates and the market’s assessment of the risk that the cash flows will not occur.
- (c) Fair value reflects the current cash equivalent rather than the price of a past transaction.

C.15 In relation to the first element of the recognition criteria, it is concluded that derivatives have an appropriate basis of measurement and it is fair value. Fair value is determined by published market transactions, or for derivatives that are not actively traded, in relation to established valuation techniques such as discounted cash flow or option pricing models.

C.16 The contractual nature of derivatives ensures that the second element of the recognition criteria is met. At any point in time, when a derivative contract is in a loss or “out of the money” position, it is expected that future economic benefits will be given up as the other party will seek to hold the government to its

obligation. Similarly where a government is “in the money” there is expectation of the ability to receive a future economic benefit.

- C.17 In applying the recognition criteria, the expectation that a future economic benefit will be obtained or given up is evaluated in relation to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain or proved. “Expected” is intended to convey that something does not have to be certain or proved to qualify as an asset or liability and recognizes that every financial instrument except cash has some inherent element of uncertainty. Fair value, based on the net future cash flows and current market conditions, provides the best measure of the expected future economic benefit or obligation of a derivative.
- C.18 Circumstances may arise where a separate item that reduces or increases the carrying amount of an asset or liability is sometimes found in financial statements. For example, an estimate of uncollectible amounts reduces receivables to the amount to be expected to be collected, or a discount may decrease the face value of a bond payable to its proceeds or present value. Those “valuation accounts” are part of the related assets or liabilities. As such, they are neither assets in their own right nor liabilities. On the other hand, a derivative contract even when entered into coincidentally and with the intention of affecting the susceptibility of another asset or liability to a change in its realizable value, is a distinct contract and, as such, is separately evaluated as an asset or liability.
- C.19 Derivatives are increasingly important tools for governments seeking to modify cash flows to mitigate risk exposures. For example, a government may enter into a commitment to purchase a capital asset to be delivered at a specified future date. Although the government has fixed the price to be paid on delivery, payment is required in a foreign currency. To ensure the cost of the asset does not vary due to fluctuations in exchange rates, a contract is entered into to fix the currency conversion rate at an agreed upon future date. As guardians of public funds, governments are expected to put in place strong internal controls to ensure derivatives are used to mitigate rather than increase risk.
- C.20 Private sector treasury managers face risks to the stability of their cash flows that are frequently not dissimilar to governments. Cash flows from assets may largely be fixed, but financing varies with interest rates. Generally speaking, other than those corporations who are “market makers” for derivatives, corporations often face similar risks and apply similar types of derivatives to manage those risks. PSAB determined that there is no merit to assertions that governments use derivatives in a manner that is fundamentally different from their application by the large majority of corporations.
- C.21 In addition to being conceptually sound, the recognition of derivatives and their measurement at fair value serves to add transparency on the use of derivatives. Reporting on their value provides evidence as to the effectiveness of strategies derivatives are being employed to facilitate. Failing to report derivatives at fair value, while acknowledging derivatives are assets and liabilities that meet

PSAB's recognition criteria would represent a significant compromise of financial reporting principles.

## **Hedge accounting**

- C.22 Hedging is an activity designed to modify a government's exposure to one or more risks by creating an offset between changes in the fair value of, or the cash flows attributable to the hedged item and the hedging instrument (or changes resulting from a particular risk exposure to those items).
- C.23 Many governments actively manage specific treasury risks, often as part of the debt management function. Derivatives are frequently used as the hedging instruments to modify aspects of future cash flow obligations in a manner more suitable to a government's own anticipated revenue streams. For instance, a government may choose to swap cash flows paying fixed and receiving interest based on a floating rate as part of a policy decision to increase the proportion of floating to fixed rate debt, anticipating that over the long term this will provide a lower effective interest rate on its borrowing portfolio.
- C.24 Recognition of derivatives at fair value in financial statements increases their visibility and indeed, this is the objective. There is understandable sensitivity that changes in the fair value of a derivative may impact measurement of short-term results. As a result, there are circumstances where some would assert that interim measurements of the value of a derivative contract entered into to protect a government against a price or exchange rate fluctuation over an extended period do not provide relevant information.
- C.25 On the other hand, the recognition of derivatives may also increase the visibility in the event that the strategies being engaged in do not represent effective responses to the risk of changes in the value of the hedged item. Possibly, the derivative is revealed not to be as effective a hedging instrument as was intended. An accounting standard needs to walk the fine line of increasing transparency to expose ineffective strategies while not transmitting false alarms to financial statement users.
- C.26 Although there is no conceptual basis for hedge accounting, PSAB believes its application is an appropriate response to situations where the hedged item may not be recognized in the accounts but the derivative hedging instrument must be reported at fair value. Further, where the hedging instrument is effective, hedge accounting addresses short-term recognition and measurement inconsistencies.
- C.27 To illustrate:
- (a) A government enters into a forward contract to manage the risk of fluctuation in foreign exchange rates relative to a commitment to purchase goods in a future period. The liability for the anticipated purchase is not presently recognized, as transfer of title for the goods has yet to occur. However, in periods following its execution the forward contract will have a fair value.

- (b) A government enters into a fixed-to-variable interest rate swap in a hedging relationship with an outstanding fixed rate debenture issue. If the swap is measured at fair value and the debt instrument is measured at amortized historical cost, the swap will generate gains or losses, whereas the debenture's carrying value will remain unchanged.

C.28 PSAB examined the following principles in relation to its own conceptual framework:

**Principles:**

Only items that meet PSAB's definitions of assets or liabilities should be reported as such on the statement of financial position.

Special accounting for items designated as being part of a hedging relationship should be provided only for qualifying items.

C.29 If one accepts the principle that derivatives are to be reported and fair value represents the best measure of a derivative's value, how should the change in the derivative's value be presented? If deferral accounting is applied, the offsetting amount for a derivative that is "in the money" is a credit. On the other hand, if the derivative's fair value represents an obligation, it would be a debit. However, losses and gains resulting from changes in the derivative instruments being used as hedging instruments should not be presented in financial statements as assets or liabilities because they do not have the essential characteristics of assets or liabilities. Specifically:

- (a) A loss on a derivative financial instrument is not an asset because no future economic benefit is associated with it. The loss cannot be exchanged for cash, or a financial asset, used to produce something of value, or used to settle liabilities.
- (b) A gain on a derivative financial instrument is not a liability because no obligation exists to sacrifice assets in the future.

C.30 The AcSB felt that losses or gains on derivative financial instruments should not be deferred and reported as assets or liabilities in the statement of financial position. The decision by management to designate a derivative as a hedging instrument does not convert a subsequent loss or gain into an asset or liability. Similarly, such deferrals cannot be reported as assets or liabilities when applying the concepts underlying PSAB's full accrual reporting model.

C.31 For entities subject to the AcSB standard, hedge accounting is optional and many organizations will choose not to apply it, avoiding requirements to document and measure effectiveness. They will separately report both the hedging instrument and hedged item at fair value. Such an approach is enabled by electing to measure the hedged item at fair value, so that gains and losses on both the hedged item and the hedging instrument are reported in net income. As outlined in the previous section, this strategy works well so long as both items are recognized in the financial statements and the nature of the hedged item and hedging instrument

are such that they do not experience unacceptable levels of short-term volatility in relation to one another.

- C.32 It is anticipated that governments will seek continued access to hedge accounting. PSAB recognizes that in developing recognition and measurement standards for derivatives it will need to give consideration to hedge accounting. However, any application of hedge accounting must be founded on a principle that the hedging relationship is documented and shown to be effective both at the outset and throughout its term. PSAB's existing hedge accounting standard<sup>2</sup> is founded on this principle.

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<sup>2</sup> See FOREIGN CURRENCY TRANSLATION, paragraph PS 2600.32.

## APPENDIX D

### IMPACT OF PROPOSALS ON KEY INDICATORS

This Appendix has been prepared to assist readers in understanding the implications of the proposal on the existing key indicators in PSAB's financial reporting model. As the material is summary in nature it may not be representative of potential applications of the principles proposed. It is intended only to illustrate key aspects of the proposals:

PSAB's government reporting model provides five key indicators as to the state of a government's finances:

1. net debt position;
2. accumulated surplus/deficit;
3. annual surplus/deficit;
4. change in net debt; and
5. cash flows in the year.

The implications of these proposals are significant and, in many cases, involve introducing standards to account for transactions and items not specifically addressed in the current PSA Handbook. In cases where no uniform standard is in place, it is difficult to definitively capture the implications of this standards proposal. Three aspects of the impact on the key indicators are addressed.

#### A: Portfolio investments traded in an active market

Key indicator	Present standard	Proposal
Net debt	Determined based on historical cost	Increases or decreases based on fair value
Accumulated surplus/deficit	Determined based on historical cost	Increases or decreases based on fair value
Annual surplus/deficit	Gains are not reflected until item sold. Losses are reflected when other than a temporary decline.	Changes in fair value impact the surplus/deficit in the period they arise.
Change in net debt	Changes reflected in the annual surplus/deficit would impact this indicator.	Changes reflected in the annual surplus/deficit would impact this indicator.
Cash flows in the year	Impacts when liquidated	No change

PSAB believes the proposal enhances the accuracy of the information provided by the indicators for net debt and accumulated surplus/deficit. This is the case as for portfolio investments traded in an active market — fair value is a better reflection of the resources a government has available. An inherent financial statement bias is removed that arises from the requirement to write down a portfolio investment that has suffered other than a temporary decline while gains are not recognized until an item is sold. Comparability between governments is enhanced by the requirement that all governments measure such investments at their fair value at the financial statement date regardless of when the investment was acquired.

Volatility in terms of the annual surplus/deficit indicator and the change in net debt may be increased and such changes are inherently unpredictable. However, PSAB believes

that the improvement to the indicators of net debt and accumulated surplus/deficit provide users with more relevant information than reporting at historical cost.

## **B: Fair value foreign currency hedging relationship<sup>1</sup>**

The hedged item is a recognized foreign currency denominated item. A government enters into a derivative to offset the risk that changes arising from future fluctuations in the exchange rate will impact surplus or deficit when the hedged item is translated into CDN\$.

Where a government has identified the nature of the specific risk exposure and designates a hedging instrument it has determined to be effective in offsetting changes in the value of the hedged item that arise due to the hedged risk, hedge accounting may be available (see FOREIGN CURRENCY TRANSLATION, Hedging of foreign currency items, Section PS 2600). These proposals contain equivalent requirements with respect to hedging relationships. However, differences arise in the presentation of hedged items and hedging instruments and in the recognition of gains and losses. The proposals require separate presentation of the hedging instrument (in many cases a derivative) and the hedged item. The gain or loss in the fair value of the derivative is measured and reported. The gain or loss on the hedged item attributable to the hedged risk adjusts the carrying amount of the hedged item<sup>2</sup>. As a result, any ineffectiveness is recognized in the statement of operations. The proposals allow for situations where no ineffectiveness may be assumed, but only where the critical terms of the hedging instrument and the hedged item match.

<b>Key indicator</b>	<b>Present standard</b>	<b>Proposal</b>
Net debt	Reporting of the hedged item is based upon the exchange rate established by the derivative contract. As such, the item is valued neither at historical cost nor the current exchange rate.	The derivative is measured at fair value separately from the hedged item which is translated at the current exchange rate. In the case of a critical terms match, there is no volatility in operating results.
Accumulated surplus/deficit	The items are financial assets and financial liabilities and, as such, the impact on this indicator is equivalent to the impact on net debt.	The items are financial assets and financial liabilities and, as such, the impact on this indicator is equivalent to the impact on net debt.
Annual surplus/deficit	Counterbalancing gains and losses that result from the translation of the components of the foreign currency hedging relationship recognized in the same period.	Gains/losses are measured on the derivative and the hedged item independently. As such, any ineffectiveness in the relationship is automatically recognized. For a critical terms match no ineffectiveness may be assumed.
Change in net debt	Changes reflected in the annual surplus/deficit would impact this indicator.	Changes reflected in the annual surplus/deficit would impact this indicator.
Cash flows in the year	Report based on category of cash flow using either the direct or indirect method.	It is not anticipated that existing guidance would change.

<sup>1</sup> The illustration assumes a qualifying and effective hedging relationship involving a derivative as the hedging instrument and a monetary item such as debt as the hedged item.

<sup>2</sup> Applies where the hedged item is measured at amortized cost. Otherwise, the hedged item is measured at fair value with gains or losses reported in the statement of operations.

These proposals improve PSAB's existing hedge accounting standard:

- (a) by requiring the measurement of derivatives at fair value and requiring any impact this may have on the key indicators to be reported; and,
- (b) because the statement of operations recognizes ineffectiveness in the hedging relationship (if any).

### **C: Cash flow foreign currency hedging relationship**

In this situation, the hedged item is an anticipated purchase of a capital asset requiring settlement in a foreign currency. The government enters into a derivative to offset the changes arising from future fluctuations in the exchange rate that will impact cash flows when the asset is acquired and the related liability recognized in CDN\$.

<b>Key indicator</b>	<b>Present standard</b>	<b>Proposal</b>
Net debt	Anticipated transactions are not included in the scope of hedging relationships recognized in the existing standard. Applying a historical cost reporting model, only the amount paid (in the case of an option) is reported. Otherwise no value is reported.	The derivative is measured at fair value, the indicator of net debt is impacted by any change in that fair value.
Accumulated surplus/deficit	There is no separate impact on this indicator.	The impact on this indicator is equivalent to the impact on net debt.
Annual surplus/deficit	Accounting would depend on policy established by the government.	Only the ineffective portion of the gain or loss on the hedging instrument would be recognized.
Change in net debt	Changes reflected in the annual surplus/deficit would impact this indicator.	The effective portion of the gain or loss on the hedging instrument is reported.
Cash flows in the year	Report based on category of cash flow using either the direct or indirect method.	It is not anticipated that existing guidance would change.

These proposals would significantly expand the scope of the present PSAB hedge accounting standard. The present hedge accounting standard is improved by:

- (a) requiring the measurement of derivatives at fair value and reporting any impact this may have on the key indicators;
- (b) establishing how gains and losses on derivatives are accounted for and facilitating a direct adjustment to the net debt indicator recognizing the legal substance of the derivative contract while mitigating volatility caused by recognition prior to realization of related cash flows on the hedged item;
- (c) setting accounting requirements for treatment of the gain or loss on resolution of the hedge including provisions permitting alternative treatments when a non-financial item (such as a capital asset) is acquired; and
- (d) recognizing ineffectiveness in the statement operations during the hedging relationship.

Appendix E provides an illustration of financial statement display.

## APPENDIX E

### ILLUSTRATIVE EXAMPLE — PRESENTATION OF A CASH FLOW HEDGE

The illustrative financial statements presented in Appendix A of FINANCIAL STATEMENT PRESENTATION, Section PS 1200, are modified to illustrate one approach to presenting a fully effective cash flow hedge in the summary financial statements of a government, while applying the principles in this SOP.

Details of the cash flow hedge and its accounting are as follows:

Government debt includes a floating rate liability of \$1,000 with five years remaining to maturity. It enters into a five-year receive-floating/pay fixed interest rate swap in the same currency and with the same principal terms as the liability, and designates it as a hedge of the exposure to variable cash flow payments on the floating rate liability attributable to interest rate risk. At inception, the fair value of the swap is zero. During the year 20X2, market interest rates increase. The government realizes \$5 in net settlements during 20X2. There is no change in the fair value of the floating rate liability, but the fair value of the derivative at March 31, 20X2 is \$50 to reflect the present value of discounted future cash flows.

## Consolidated Statement of Financial Position

For the year ended March 31, 20X2 (\$ millions)	<u>20X2</u>	<u>20X1</u>
<b>Financial assets</b>		
Cash and cash equivalents	1,577	1,366
Accounts receivable	1,864	1,708
Portfolio investments	2,172	1,273
Commercial enterprises equity	331	207
Loans	4,909	5,659
Inventories for resale	109	135
	<u>10,962</u>	<u>10,348</u>
<b>Liabilities</b>		
Accounts payable and accrued liabilities	2,383	2,644
Debt	5,575	5,768
Debt of municipal financing corporation	3,788	4,028
Pension obligations	4,813	4,890
Other accrued liabilities	1,395	1,510
Deferred revenue	308	331
	<u>18,262</u>	<u>19,171</u>
<b>Net debt</b>	<u>(7,300)</u>	<u>(8,823)</u>
<b>Non-financial assets</b>		
Tangible capital assets	7,218	7,215
Inventories of supplies	112	222
Prepaid expenses	30	20
	<u>7,360</u>	<u>7,457</u>
<b>Accumulated surplus/(deficit)</b>	<u>60</u>	<u>(1,366)</u>

Includes a derivative with a fair value of \$50.

Indicators of net debt and accumulated surplus reflect the fair value of a derivative at the reporting date.

## Consolidated Statement of Operations

For the year ended March 31, 20X2 (\$ millions)	20X2 <u>Budget</u>	20X2 <u>Actual</u>	20X1 <u>Actual</u>
<b>Revenues</b>			
Personal income tax	5,392	5,969	5,655
Corporate taxes	2,642	2,659	3,848
Sales tax	1,265	1,408	1,543
Fuel tax	470	547	558
Tobacco tax	345	341	330
Lottery revenues	660	770	705
Health insurance premiums	641	680	652
Fees, permits, licenses and fines	581	651	669
Liquor commission	427	485	465
Income from enterprises	50	525	97
Miscellaneous revenues	100	342	402
Investment income	409	610	747
Canada Health and Social Transfer	940	970	903
Other transfers	355	365	280
	<u>14,277</u>	<u>16,322</u>	<u>16,854</u>
<b>Expenses</b>			
Education	4,329	4,287	4,168
Health	4,541	4,626	4,457
Agriculture, environment, development	1,706	1,856	1,740
Social services	1,654	1,701	1,709
Transportation and utilities	626	823	807
Recreation and culture	281	272	217
General government	551	627	560
Justice	468	487	462
Interest expense	93	267	183
	<u>14,249</u>	<u>14,946</u>	<u>14,303</u>
<b>Annual surplus</b>	<u>28</u>	<u>1,376</u>	<u>2,551</u>

Gain on a derivative of \$5 may be offset in reporting interest or reported in revenue.

**Consolidated Statement of Change in  
Accumulated Surplus/(Deficit)**

To account for a gain on a derivative determined to be an effective hedge.

For the year ended March 31, 20X2 (\$ millions)	20X2	20X2	20X1
	<u>Budget</u>	<u>Actual</u>	<u>Actual</u>
<b>Annual surplus</b>			
Accumulated deficit at beginning of year	(1,366)	(1,366)	(3,917)
Annual surplus	28	1,376	2,551
Change in fair value of cash flow hedge	<u>—</u>	<u>50</u>	<u>—</u>
Accumulated surplus/(deficit) at end of year	<u>(1,338)</u>	<u>60</u>	<u>(1,366)</u>

**Consolidated Statement of Change In Net Debt**

To report all gains during the period on a derivative.

For the year ended March 31, 20X2 (\$ millions)	20X2	20X2	20X1
	<u>Budget</u>	<u>Actual</u>	<u>Actual</u>
	<u>28</u>	<u>1,376</u>	<u>2,551</u>
Gain on cash flow hedge	—	55	—
Gain on cash flow hedge reclassified to interest expense	—	(5)	—
Acquisition of tangible capital assets	(294)	(294)	(250)
Amortization of tangible capital assets	226	226	230
(Gain)/loss on sale of tangible capital assets	0	(5)	(19)
Proceeds on sale of tangible capital assets	0	46	72
Write-downs of tangible capital assets	<u>0</u>	<u>24</u>	<u>44</u>
	<u>(68)</u>	<u>47</u>	<u>77</u>
Acquisition of supplies inventories	0	0	(324)
Acquisition of prepaid expense	0	(30)	(20)
Consumption of supplies inventories	0	110	102
Use of prepaid expense	<u>0</u>	<u>20</u>	<u>0</u>
	<u>0</u>	<u>100</u>	<u>(242)</u>
<b>(Increase)/decrease in net debt</b>	(40)	1,523	2,386
<b>Net debt at beginning of year</b>	<u>(8,823)</u>	<u>(8,823)</u>	<u>(11,209)</u>
<b>Net debt at end of year</b>	<u>(8,863)</u>	<u>(7,300)</u>	<u>(8,823)</u>

To account for a portion of the gain on a derivative reclassified to interest expense.

## APPENDIX F

### DISCLOSURES

This Appendix sets out disclosures to support the principles proposed specific to recognition and measurement of financial instruments. The objective is to assist users of summary financial statements in understanding the significance of financial instruments to a government's financial position and changes in financial position. This document does not include details of disclosures involving the nature and extent of risks arising from financial instruments. These details will be incorporated into the eventual exposure draft.

#### Statement of financial position

- F.01 If a government has designated a financial asset or a financial liability (or a group of financial assets or financial liabilities) as a financial instrument carried at fair value, it should separately disclose the aggregate carrying value of the items designated for each category on the statement of financial position that includes designated items.
- F.02 If a government has designated a loan or receivable (or a group of loans or receivables) as a financial instrument carried at fair value, it should disclose:
- (a) the maximum exposure to credit risk of the loan or receivable (or group of loans or receivables) at the reporting date.
  - (b) the amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk.
  - (c) the amount of change, during the period and cumulatively, in the fair value of the loan or receivable (or group of loans or receivables) that is attributable to changes in the credit risk of the financial asset determined either:
    - (i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or
    - (ii) using an alternative method the government believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset.  
Changes in market conditions that give rise to market risk include changes in an observed (benchmark) interest rate, commodity price, foreign exchange rate or index of prices or rates.
  - (d) the amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the loan or receivable was designated.
- F.03 If a government has designated a financial liability (or a group of financial liabilities) as a financial instrument carried at fair value, it should disclose:
- (a) the amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability determined either:

- (i) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or
- (ii) using an alternative method the government believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the liability.

Changes in market conditions that give rise to market risk include changes in a benchmark interest rate, the price of another entity's financial instrument, a commodity price, a foreign exchange rate or an index of prices or rates. For contracts that include a unit-linking feature (i.e., the return on the contract is linked to the return on an identified asset or pool of assets), changes in market conditions include changes in the performance of the related asset(s).

- (b) the difference between the financial liability's carrying amount and the amount the government would be contractually required to pay at maturity to the holder of the obligation.

F.04 The government should disclose:

- (a) the methods used to comply with the requirements in paragraphs F.02(c) and F.03 (a); and
- (b) if the government believes that the disclosure it has given to comply with the requirements in paragraph F.02(c) or F.03(a) does not faithfully represent the change in the fair value of the financial asset or financial liability attributable to changes in its credit risk, the reasons for reaching this conclusion and the factors it believes are relevant.

F.05 If the government has in the period reclassified a financial asset or financial liability as one measured:

- (a) at cost or amortized cost, when it was categorized as a financial instrument carried at fair value; or
- (b) a financial instrument carried at fair value, when it was reported at cost or amortized cost;

it should disclose the amount reclassified into and out of each category and the reason for that reclassification.

F.06 When financial assets are impaired by credit losses and the government records the impairment in a separate account (for example, a valuation allowance used to record individual impairments or a similar account used to record a collective impairment of assets) rather than directly reducing the carrying value of the asset (for example, a write-off), it should disclose a reconciliation of changes in that account during the period for each class of financial assets.

F.07 The foregoing provisions provide transparency by providing users with supporting information to understand the extent to which a government has applied the designation for financial instruments carried at fair value. For those situations where governments designate loans and receivables as items to be carried at fair value, users will be provided with information necessary to evaluate credit risk and the extent to which credit derivatives have been applied, as part of a strategy to reduce that credit risk. In the case of financial liabilities, the

disclosures will assist readers in evaluating the extent to which the carrying value has been impacted by changes in the credit status of the issuer and any variance in the carrying amount as compared to the contractual repayment obligation.

- F.08 LOANS RECEIVABLE, Section PS 3050, does not presently require governments to disclose a reconciliation of changes in valuation allowances. This requirement, which parallels AcSB and IASB standards, supports the proposed principle in providing users with information that is valuable in understanding changes in a government's financial position.
- F.09 Users require this information to evaluate the significance of decisions made by a government and to compare governments on a consistent basis. These proposals are significantly less onerous than provisions in other standards that impose broad requirements to disclose fair values for all financial asset and financial liability categories. The decision not to require the preparation and disclosure of this information is in line with PSAB's decision not to mandate broad use of fair value reporting at this time.

### **Statement of operations**

- F.10 A government should disclose the following items of revenue, expense, gains or losses, either on the face of the financial statements or in the notes:
- (a) net gains or losses on:
    - (i) financial instruments carried at fair value, showing separately those on financial instruments designated at fair value and those on financial instruments that are required to be reported at fair value;
    - (ii) portfolio investments other than portfolio investments quoted in an active market; and
    - (iii) all other financial assets and financial liabilities carried at cost and amortized cost;
  - (b) total interest income and total interest expense (calculated using the effective interest method) for financial assets and financial liabilities that are carried at cost and amortized cost; and
  - (c) the amount of any impairment loss for each class of financial asset.

### **Other disclosures**

- F.11 PSAB proposes to amend FINANCIAL STATEMENT PRESENTATION, Section PS 1200, to require that a government disclose for each class of financial instrument presented, the basis of measurement and where that basis of measurement is fair value, the methods used in determining fair value.

## Hedge accounting disclosures

- F.12 The aggregate and detailed disclosures set out in the paragraphs that follow are proposed for a government's cash flow and fair value hedges.
- F.13 A government using fair value hedge accounting should disclose:
- (a) a description of fair value hedge accounting;
  - (b) a description of the financial instruments designated as hedging instruments and their fair values at the reporting date; and
  - (c) the nature of the risks being hedged.
- F.14 A government using cash flow hedge accounting should disclose:
- (a) a description of cash flow hedge accounting;
  - (b) the periods when the cash flows are expected to occur and when they are expected to affect surplus or deficit in the period;
  - (c) a description of any forecast transaction for which hedge accounting had previously been used, but which is no longer expected to occur;
  - (d) the amount that was recognized in the statement of changes in net debt for the period;
  - (e) the amount that was transferred from the statement of changes in net debt and included in revenues and expenses for the period, showing the amount included in each line item in the statement of operations; and
  - (f) the amount that was removed from net debt during the period and included in the initial cost or other carrying amount of a non-financial asset or a non-financial liability whose acquisition or incurrence was a hedged highly probable transaction.
- F.15 A government should separately disclose:
- (a) for fair value hedges, gains or losses:
    - (i) on the hedging instrument; and
    - (ii) on the hedged item attributable to the hedged risk and
  - (b) the ineffectiveness recognized in surplus or deficit for the period that arises from cash flow hedges.

## APPENDIX G

### REPORTING OF GAINS AND LOSSES ON CASH FLOW HEDGING INSTRUMENTS

PSAB examined the alternative of requiring that the statement of operations reflect all gains and losses on derivatives, including those used to hedge future cash flows. The SOP does not adopt this position, adopting a position that cash flow hedge accounting is needed to address a fundamental mismatch. This mismatch arises when a derivative is used to hedge future cash flows. In common with the AcSB standards, gains and losses on cash flow hedging instruments are not recognized in the statement of operations until the cash flows that are the subject of the hedge are reported.

This Appendix explores opposing views on this question, and illustrates the impact of applying the same fact situation as presented in Appendix E. Arguments in support of recognizing all gains and losses in the statement of operations are as follows:

- (a) The purpose of the statement of operations is to report on all changes in the economic resources of a government occurring during the reporting period. The fact that recognition inconsistencies arise when a derivative (recognized) is designated to hedge future cash flows (yet to be recognized) does not justify a departure from this fundamental requirement. If it is important enough to recognize the hedging instrument separately as an asset or liability at its fair value, on the basis that it meets the definition of an asset or liability, it is important enough to recognize the effect on the statement that explains the changes in the net economic resources.
- (b) Permitting a departure from the requirement that all changes in assets and liabilities be reported in the Statement of Operations will lead to efforts to justify other departures from this principle, especially based on “matching” and “volatility” arguments.
- (c) Hedge accounting in accommodating the reporting of gains and losses in one period when they would otherwise be reported in another period, tacitly supports condensing performance of a government into one bottom-line number. When the “new” reporting model was adopted, considerable emphasis was placed and resources expended on getting out the message that financial position and performance are too complex to be captured in a single bottom-line number.
- (d) To determine accounting standards on the basis of economic consequences makes financial statements less reliable. FINANCIAL STATEMENT CONCEPTS, paragraph PS 1000.29, indicates that accounting information is *reliable* if it is neutral:

“Information is neutral when it is free from bias that would lead users toward making decisions that are influenced by the way the information is measured or presented. . . In the selection of accounting principles, bias may occur when the selection is made with the interests of particular users or with particular economic or political objectives in mind. . . It is, above all, the predetermination of a desired result, and the consequential selection of information to induce that result, that negates neutrality in accounting.”

Increasing complexity of financial information also makes it less useful. Paragraph PS 1000.31 states that “Users need information presented clearly and simply. For the information provided...to be useful, it must be capable of being understood by users.”

- (e) The statement of operations already includes items over which the government has no budgetary control. The challenge is to find a better way to display the revenues, gains, expenses and losses that are recognized. The emphasis should be on display and how best to report the changes in net assets rather than trying to determine what should or should not be included in the bottom-line surplus or deficit number.

The proposal enables cash flow hedge accounting through reporting of gains and losses on cash flow hedging instruments in the statement of net debt. In adopting the alternative presented in the SOP, PSAB determined the following:

- (a) A reporting mismatch can arise when entities enter into arrangements to mitigate the impact on cash flows of future periods using derivatives. This is acknowledged by recognizing changes in the value of the derivative outside of the statement of operations until the future cash flow is determined. Hedge accounting, a departure from the conceptual framework, permits recording of a gain or loss in one period when it would otherwise be recorded in another period. Limited to specific qualifying hedging relationships and subject to prospective as well as retrospective testing, it modifies the timing of recognition of gains/losses on the hedging instrument.
- (b) The approach requires recognition of ineffectiveness in the hedging relationship and reporting of derivatives at fair value. Provision for cash flow hedge accounting conforms to the AcSB standards. PSAB was not persuaded by arguments that standards for reporting by governments should be set in a manner that would eliminate access to cash flow hedge accounting. To do this would mean entities executing a similar transaction but reporting under the AcSB standards would report results fundamentally differently than governments.
- (c) Responses from several large provincial governments highlighted the need for a standard that acknowledges the use of derivatives in the management of fluctuations in future cash flows arising due to changes in rates of interest and foreign exchange. Recognizing all gains and losses on cash flow hedging instruments would impact the reporting of risk management outcomes specific to those types of debt issues.

The illustration below applies the same fact situation presented in Appendix E. In this case, the gain on the cash flow hedging instrument arising from its remeasurement at fair value is fully recognized in the statement of operations. It reflects the impact of adopting the position that all gains and losses arising on remeasurement at fair value should be reported in the statement of operations. This position was not adopted in the SOP.

### Consolidated Statement of Financial Position

As at March 31 (\$ millions)		<u>20X2</u>	<u>20X1</u>
<b>Financial assets</b>	Includes a derivative with a fair value of \$50		
Cash and cash equivalents		1,577	1,366
Accounts receivable		1,864	1,708
Portfolio investments		2,172	1,273
Commercial enterprises equity		331	207
Loans		4,909	5,659
Inventories for resale		109	135
		<u>10,962</u>	<u>10,348</u>
<b>Liabilities</b>			
Accounts payable and accrued liabilities		2,383	2,644
Debt		5,575	5,768
Debt of municipal financing corporation		3,788	4,028
Pension obligations		4,813	4,890
Other accrued liabilities		1,395	1,510
Deferred revenue		308	331
		<u>18,262</u>	<u>19,171</u>
<b>Net debt</b>		<u>(7,300)</u>	<u>(8,823)</u>
<b>Non-financial assets</b>	Indicators of net debt and accumulated surplus reflect the fair value of a derivative at the reporting date.		
Tangible capital assets		7,218	7,215
Inventories of supplies		112	222
Prepaid expenses		30	20
		<u>7,360</u>	<u>7,457</u>
<b>Accumulated surplus/(deficit)</b>		<u>60</u>	<u>(1,366)</u>

## Consolidated Statement of Operations

For the year ended March 31 (\$ millions)	20X2	20X2	20X1
<b>Revenues</b>	<u>Budget</u>	<u>Actual</u>	<u>Actual</u>
Personal income tax	5,392	5,969	5,655
Corporate taxes	2,642	2,659	3,848
Sales tax	1,265	1,408	1,543
Fuel tax	470	547	558
Tobacco tax	345	341	330
Lottery revenues	660	770	705
Health insurance premiums	641	680	652
Fees, permits, licenses and fines	581	651	669
Liquor commission	427	485	465
Income from enterprises	50	525	97
Miscellaneous revenues	100	342	402
Investment income	409	610	747
Canada health and social transfer	940	970	903
Other transfers	<u>355</u>	<u>365</u>	<u>280</u>
	<u>14,277</u>	<u>16,322</u>	<u>16,854</u>
<b>Expenses</b>			
Education	4,329	4,287	4,168
Health	4,541	4,626	4,457
Agriculture, environment, development	1,706	1,856	1,740
Social services	1,654	1,701	1,709
Transportation and utilities	626	823	807
Recreation and culture	281	272	217
General government	551	627	560
Justice	468	487	462
Interest expense	<u>93</u>	<u>267</u>	<u>183</u>
	<u>14,249</u>	<u>14,946</u>	<u>14,303</u>
Unrealized gain on derivative	28	1,376	2,551
	<u>—</u>	<u>50</u>	<u>—</u>
<b>Annual surplus</b>	<u>28</u>	<u>1,426</u>	<u>2,551</u>

The increase in the value of the derivative of \$55 is reported on the statement of operations. The \$50 not associated with period cash flows is shown separate from the \$5 that offsets interest expense.

**Comments:**

- Fair value of the derivative reported on the statement of financial position and indicators of net debt and accumulated surplus/deficit are consistent with the proposal (Appendix E).
- Annual surplus indicator reports \$1,426 reflecting full period gain on derivative. Cash flow hedge accounting measures period surplus at \$1,376 (Appendix E).
- As the increase in the derivative's fair value is fully reflected in operations, no amounts are reported on the statement of changes in accumulated surplus/deficit or on the statement of changes in net debt.

**Consolidated Statement of Change in  
Accumulated Surplus/(Deficit)**

For the year ended March 31 (\$ millions)	20X2	20X2	20X1
<b>Annual surplus</b>	<u>Budget</u>	<u>Actual</u>	<u>Actual</u>
Accumulated deficit at beginning of year	(1,366)	(1,366)	(3,917)
Annual surplus	<u>28</u>	<u>1,426</u>	<u>2,551</u>
Accumulated surplus/(deficit) at end of year	<u>(1,338)</u>	<u>60</u>	<u>(1,366)</u>

**Consolidated Statement of Change in Net Debt**

For the year ended March 31 (\$ millions)	20X2	20X2	20X1
	<u>Budget</u>	<u>Actual</u>	<u>Actual</u>
<b>Annual surplus</b>	<u>28</u>	<u>1,426</u>	<u>2,551</u>
Acquisition of tangible capital assets	(294)	(294)	(250)
Amortization of tangible capital assets	226	226	230
(Gain)/loss on sale of tangible capital assets	0	(5)	(19)
Proceeds on sale of tangible capital assets	0	46	72
Write-downs of tangible capital assets	<u>0</u>	<u>24</u>	<u>44</u>
	<u>(68)</u>	<u>(3)</u>	<u>77</u>
Acquisition of supplies inventories	0	0	(324)
Acquisition of prepaid expense	0	(30)	(20)
Consumption of supplies inventories	0	110	102
Use of prepaid expense	<u>0</u>	<u>20</u>	<u>0</u>
	<u>0</u>	<u>100</u>	<u>(242)</u>
<b>(Increase)/decrease in net debt</b>	(40)	1,523	2,386
<b>Net debt at beginning of year</b>	<u>(8,823)</u>	<u>(8,823)</u>	<u>(11,209)</u>
<b>Net debt at end of year</b>	<u>(8,863)</u>	<u>(7,300)</u>	<u>(8,823)</u>

## APPENDIX H

### SYNTHETIC INSTRUMENT ACCOUNTING

PSAB considered synthetic instrument accounting, given its present application by governments. FOREIGN CURRENCY TRANSLATION, paragraph PS 2600.06(n), states: “synthetic instrument accounting is a method of accounting for the assets and liabilities in a synthetic instrument relationship as though they were the item being emulated.”

However, synthetic instrument accounting violates the principle of measuring derivatives at fair value and results in netting assets against liabilities. For these reasons, in common with the approach adopted by the AcSB and IASB, these proposals generally eliminate synthetic instrument accounting. This Appendix explores views presented by its advocates and illustrates its application applying the same fact situation as Appendix E.

Synthetic instrument accounting is commonly applied in reporting items where exchange risk or interest rate risk has been modified through the use of derivatives.

For example, a government may have two scenarios for a debt issue:

Scenario A — issue a loan of CA\$723M; or

Scenario B — issue a loan of US\$500M and enter into a receive US\$500M/payCA\$723M currency swap with the same characteristics as the liability (interest rate, maturity, etc.).

Scenario A	
Debt	CA\$723M
Total	CA\$723M

Scenario B	
Debt	US\$500M
Swap :	
Receive	US\$500M
Pay	CA\$723M
Total	CA\$723M

If the effective cash flows are identical, why are elements presented separately?

In the two cases:

- (a) final payment is the same = CA\$723M; and
- (b) interest payments will be the same and at the same date.

To record the derivatives at fair value will induce readers to believe that one transaction has more volatility than the other, which is not true.

Rules similar to hedging could be established: to provide documentation; and demonstrate that economic substance is achieved (for example, CA\$ debt).

To compensate, fair values of individual elements could be disclosed in the notes to the financial statements

The advantages are as follows:

- (a) reflects economic substance and intent;
- (b) simple and consistent (no OCI, or entries to adjust changes in net debt);
- (c) could be supplemented by fair value disclosure on derivatives; and
- (d) since swap and debt have exactly the same cash flows, it avoids creating an artificial difference based on fair value determination.

Synthetic instrument accounting meets most of the four basic principles:

- (a) derivatives would be recorded and presented as part of the long term debt;
- (b) the fair value of derivatives would be disclosed in the notes to financial statement;
- (c) there will be no deferred assets or liabilities; and
- (d) documentation and other guidelines will apply.

PSAB does not support continued use of synthetic instrument accounting for the following reasons:

- (a) Combining a derivative and the hedged item to report only the net effect of the individual contracts violates two principles. The principles violated are:
  - (i) fair value is the only relevant measurement basis for derivatives; and
  - (ii) a financial asset and a financial liability should be offset and the net amount reported in the statement of financial position when, and only when, a government:
    - currently has a legally enforceable right to set off the recognized amounts; and
    - intends to settle on a net basis, or to realize the asset and settle the liability simultaneously.
- (b) Derivatives can be and are managed separately from risk exposures they may have been acquired to offset. Circumstances, whether external, such as a credit event, or internal, such as a change in intentions, can occur. Reporting two contracts as one fails to faithfully represent the assets and liabilities associated with each contract.
- (c) Understanding derivatives and their impact on the financial position are challenging concepts for many financial statement users to understand. To overcome this, derivatives are reported at fair value irrespective of their application. Permitting synthetic instrument accounting violates this universality.
- (d) Where the criteria of a critical terms match are met, the SOP effectively permits synthetic instrument accounting within the statement of operations. Volatility for the indicator of surplus/deficit is not at issue.
- (e) Synthetic instrument accounting would cause a GAAP difference relative to equivalent standards adopted for entities applying the AcSB standards giving rise to inconsistent reporting of otherwise equivalent transactions.
- (f) PSAB's proposal improves the existing standard by focusing attention on identification of situations where the hedging instrument fails to fully offset changes in the carrying value of the hedged item specific to the hedged risk (ineffectiveness).

The illustration below applies the same fact situation presented in Appendix E. In this case, synthetic instrument accounting is applied. It reflects the measurement and reporting of two separate contracts (qualifying as a critical terms match) based on net contractual terms. This position was not adopted in the SOP.

### Consolidated Statement of Financial Position

As at March 31 (\$ millions)	<u>20X2</u>	<u>20X1</u>
<b>Financial assets</b>		
Cash and cash equivalents	1,577	1,366
Accounts receivable	1,864	1,708
Portfolio investments	2,122	1,273
Commercial enterprises equity	331	207
Loans	4,909	5,659
Inventories for resale	<u>109</u>	<u>135</u>
	<u>10,912</u>	<u>10,348</u>
<b>Liabilities</b>		
Accounts payable and accrued liabilities	2,383	2,644
Debt	5,575	5,768
Debt of municipal financing corporation	3,788	4,028
Pension obligations	4,813	4,890
Other accrued liabilities	1,395	1,510
Deferred revenue	<u>308</u>	<u>331</u>
	<u>18,262</u>	<u>19,171</u>
<b>Net debt</b>	<u>(7,350)</u>	<u>(8,823)</u>
<b>Non-financial assets</b>		
Tangible capital assets	7,218	7,215
Inventories of supplies	112	222
Prepaid expenses	<u>30</u>	<u>20</u>
	<u>7,360</u>	<u>7,457</u>
<b>Accumulated surplus/(deficit)</b>	<u>10</u>	<u>(1,366)</u>

**Comments:**

- The fact situation is considered to create synthetic fixed rate debt by combining the receive-floating/pay-fixed interest rate swap and a floating rate debt instrument. The debt obligation is reported at its face value, the derivative is not reported on the statement of financial position.
- The measures of net debt and accumulated surplus/deficit do not take into account the fair value of the derivative of \$50.
- The cash settlement of \$5 realized during the period is reported on the statement of operations. As such, display on the statement of operations is identical to the SOP proposal (Appendix E).
- As the fair value of the derivative is not reported on the statement of financial position, no entries are made on the statement of change in surplus (deficit) or on the statement of changes in net debt. Information as to the fair value of the derivative is disclosed in the notes.

## Consolidated Statement of Operations

For the year ended March 31 (\$ millions)	20X2	20X2	20X1
<b>Revenues</b>	<u>Budget</u>	<u>Actual</u>	<u>Actual</u>
Personal income tax	5,392	5,969	5,655
Corporate taxes	2,642	2,659	3,848
Sales tax	1,265	1,408	1,543
Fuel tax	470	547	558
Tobacco tax	345	341	330
Lottery revenues	660	770	705
Health insurance premiums	641	680	652
Fees, permits, licenses and fines	581	651	669
Liquor commission	427	485	465
Income from enterprises	50	525	97
Miscellaneous revenues	100	342	402
Investment income	409	610	747
Canada health and social transfer	940	970	903
Other transfers	<u>355</u>	<u>365</u>	<u>280</u>
	<u>14,277</u>	<u>16,322</u>	<u>16,854</u>
<b>Expenses</b>			
Education	4,329	4,287	4,168
Health	4,541	4,626	4,457
Agriculture, environment, development	1,706	1,856	1,740
Social services	1,654	1,701	1,709
Transportation and utilities	626	823	807
Recreation and culture	281	272	217
General government	551	627	560
Justice	468	487	462
Interest expense	<u>93</u>	<u>267</u>	<u>183</u>
	<u>14,249</u>	<u>14,946</u>	<u>14,303</u>
<b>Annual surplus</b>	<u>28</u>	<u>1,376</u>	<u>2,551</u>

Gain on a derivative of \$5 is offset in the reporting interest. This presentation reflects the view that this is in substance a fixed-rate debt and the \$5 represents a reduction in the interest rate, not a gain on a derivative.

**Consolidated Statement of Change in  
Accumulated Surplus/(Deficit)**

For the year ended March 31 (\$ millions)	20X2	20X2	20X1
<b>Annual surplus</b>	<u>Budget</u>	<u>Actual</u>	<u>Actual</u>
Accumulated deficit at beginning of year	(1,366)	(1,366)	(3,917)
Annual surplus	<u>28</u>	<u>1,376</u>	<u>2,551</u>
Accumulated surplus/(deficit) at end of year	<u>(1,338)</u>	<u>10</u>	<u>(1,366)</u>

**Consolidated Statement of Change in Net Debt**

For the year ended March 31 (\$ millions)	20X2	20X2	20X1
	<u>Budget</u>	<u>Actual</u>	<u>Actual</u>
<b>Annual surplus</b>	<u>28</u>	<u>1,376</u>	<u>2,551</u>
Acquisition of tangible capital assets	(294)	(294)	(250)
Amortization of tangible capital assets	226	226	230
(Gain)/loss on sale of tangible capital assets	0	(5)	(19)
Proceeds on sale of tangible capital assets	0	46	72
Write-downs of tangible capital assets	<u>0</u>	<u>24</u>	<u>44</u>
	<u>(68)</u>	<u>(3)</u>	<u>77</u>
Acquisition of supplies inventories	0	0	(324)
Acquisition of prepaid expense	0	(30)	(20)
Consumption of supplies inventories	0	110	102
Use of prepaid expense	<u>0</u>	<u>20</u>	<u>0</u>
	<u>0</u>	<u>100</u>	<u>(242)</u>
<b>(Increase)/decrease in net debt</b>	(40)	1,473	2,386
<b>Net debt at beginning of year</b>	<u>(8,823)</u>	<u>(8,823)</u>	<u>(11,209)</u>
<b>Net debt at end of year</b>	<u>(8,863)</u>	<u>(7,350)</u>	<u>(8,823)</u>

**Notes to the Financial Statements**

In addition to disclosures required in support of the principles to enable users to evaluate the significance of the nature and extent of risks arising from financial instruments, and the significance of financial instruments to a government's financial position and changes in its financial position, details of the fair value of derivatives held would be made.